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DEPARTMENTS

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PRICE-LEVEL ADJUSTMENTS: FETISH IN ACCOUNTING

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THE LITERATURE of accounting since the end of World War II must certainly be unique among the professional literatures in at least one respect: the vehement insistence by respected members of the profession, both practicing and academic, that accounting reports in this period of rising price levels have been and continue to be incorrect and misleading. These should be serious charges when made in public (as they have been) and when fully documented and authenticated. The evidence submitted thus far fortunately seems not to have been fully convincing, for with no more visible progress than has been made to cure the alleged defects, the profession of accounting, as well as the financial statements which symbolize the profession, should certainly otherwise have gone into a state of eclipse.

Since 1948 there has been a steady flow of articles on the implications of the price level changes for accounting reports, by far the larger portion agreeing that these changes had undermined the reliability of the conventional financial statements. Between World War I and World War II there had been a very substantial amount of writing with a quite similar import. This earlier period produced Henry W. Sweeney's *Stabilized Accounting*, as well as the acquiescence of accountants in property write-ups on the basis of appraisals, if appropriately disclosed, and dealt with thereafter. Both these were essentially descriptions of routines to be followed, the procedures being vaguely justified as "relevant to the customary aim of economic effort" (the preservation and enhancement of purchasing power)[1] or as the manner in which to get on the books "effective, economically significant costs."[2] The current phase of the discussion has really produced little that is new, a number of writers[3] crediting Sweeney with having done a definitive job in the area. Actually, there has been some retreat from the Sweeney model for price level adjustments if we judge by the proposals contained in "Price Level Changes and Financial Statements,"[4] promulgated in 1951 by the Com-

[1] Henry W. Sweeney, *Stabilized Accounting* (New York: Harpers, 1936), p. 6.

[2] Paton and Littleton, *An Introduction to Corporate Accounting Standards*, p. 131.

[3] W. A. Paton, "Measuring Profits Under Inflation Conditions," *Journal of Accountancy*, January, 1950, p. 27; D. H. Mackenzie, "Contemporary Theories of Corporate Profits Reporting," ACCOUNTING REVIEW, October, 1949, p. 362.

[4] ACCOUNTING REVIEW, October, 1951, pp. 468-474. Hereafter the reference will be simply designated as Supplementary Statement No. 2. Supplementary Statement No. 2 will be taken as an authoritative and sympathetic statement of the current thought on price level adjustments of financial statements. Of the seven members of the promulgating committee only two had not written on the subject and so their views cannot be specifically analyzed. The other five can be judged by their articles to be sympathetic to price level adjustment. Six consultants to the committee were also listed and only one of this group had not expressed his views

mittee on Accounting Concepts and Standards of the American Accounting Association and designated as Supplementary Statement No. 2 to the 1948 Revision of *Accounting Concepts and Standards Underlying Corporate Financial Statements*. Whereas Sweeney would have departed substantially from historical dollar costs in his system, Supplementary Statement No. 2 proposes that "the primary financial statements" shall continue to reflect historical dollar costs, and supplementary statements will be prepared which will "present the effects of the fluctuations in the value of the dollar upon net income and upon financial position." But Supplementary Statement No. 2 is very vague on the use to which these adjusted financial statements would be put—". . . there is substantial evidence that important *informational* benefits would be derived from a restatement of accounting data in terms of a monetary unit of uniform significance."[5] After nearly thirty years of discussion, that price level adjustments would be justified on such vague grounds as providing "important informational benefits," is well-nigh unbelievable. Price level adjustments have surely become a fetish in accounting: they are advocated widely without a satisfactory statement of either the concept or the use.

I

Expressions of dissatisfaction with conventionally prepared financial statements are widest in periods of rising price levels. At times such as these the detractors of accounting statements bemoan the fact that these statements do not use figures which represent "economic realities," whether asset values, or costs of production, or net income. It is suggested, if not explicitly stated, that in "normal" times there is probably not much divergence between, say, economic income and accounting net income; but in times of rising price levels the gap between the two perimeters becomes wide enough to be significant and since it is economic income that is "true" income, accounting techniques and reports should be revised to come closer to this "true" figure. Thus Supplementary Statement No. 2, which does not once contain the word "economic" in its text, has for its purpose, according to one of the members of the promulgating committee, just such an adjustment.

> While it does not attempt to define "economic income," the committee makes it evident that, to the extent such a concept can be measured in accounting terms, this is its general objective.[6]

It is not enough to state an ideal—the approximation of economic income "in accounting terms," in this case. The statement that the committee did not attempt to define economic income contains a curious double implication. The failure to define a concept might be taken, on the one hand, to mean that the term is already so well understood that explanation is superfluous; on the other hand, the reference to the "attempt" to define suggests that economic income is a most difficult concept with which to work. The latter is, of course, the case and this in turn suggests the source of the major difficulties with the whole problem of price level adjustments of financial statements.

A major tool in the task of ascertaining and measuring economic (real) income is the index number, and Supplementary Statement No. 2 advocates the use of a *general* price index, the index of wholesale prices being suggested. But it is assumed, without even so much as discussing the validity of the assumption, that account-

on this subject; one other (Howard Greer) should probably be classed as critical of price level adjustments.

[5] *Ibid.*, pp. 472, 470. (Italics supplied.)

[6] Maurice Stans, "AAA Proposals Offer Practical Suggestions for Dealing with Price Level Changes in Accounting," *Journal of Accountancy*, January, 1952, p. 57.

ing data can be converted into relevant data for the calculation of economic income by applying index number adjustments to the accounting data. It is also assumed, without examination of the assumption, that it is possible to measure the relative well being (economic income) of a particular individual in a group with the same devices that have been found appropriate for the group to which he belongs. Thus, it might be reasonable to determine whether the real income of factory workers had increased or decreased over a period by comparing, say, the changes in the index of the cost of living with the changes in the average hourly earnings of workers in manufacturing industries. It does not follow that this procedure also describes the change in real income of every factory worker, or even of any particular worker or group of workers. It also assumes, without examination, that it is meaningful to speak of the real income of a business enterprise in the same manner as is done for groups of individuals.

That the problem of defining the concept of economic income (as distinguished from measuring it) is a difficult one will not be denied. Even J. B. Canning, who is unusually lucid on most topics, found this a most difficult assignment. The bridge between the economist's (Fisher's) and the accountant's express or implied definitions of income was a very shaky one; and Canning noted with respect to the Fisher concept, that "no bounds are set to it by obstacles insuperable to statistical procedure."[7] And though Canning expressed the opinion that accountants would prefer a "purchasing power accounting" if the means therefor were available,[8] he did not so much as suggest that an index number adjustment to the conventional "dollar accounting" (as he put it) would accomplish the trick. Even on the basis of an inadequately formulated theory of income, there is no basis in economic theory for believing price level adjustments applied to accounting data would result in an adjusted accounting income which would closely approximate economic income.

In what may be called modern economic theory there is respectable opinion that the concept of economic income is not a serviceable one in the analysis of the workings of a dynamic economic system (a system in which, among other things, price level changes can occur). Thus J. R. Hicks, in a work published in 1939, had this to say with respect to a number of concepts conventionally used in economic analysis, income being one:

> In spite of their familiarity, I do not believe that they are suitable tools for any analysis which aims at logical precision. There is far too much equivocation in their meaning, equivocation which cannot be removed by the most painstaking effort. At bottom, they are not logical categories at all; they are rough approximations, used by the business man to steer himself through the bewildering changes of situation which confront him.[9]

On the concept of income which Hicks thinks most useful, he has this to say:

> The purpose of income calculations in practical affairs is to give people an indication of the amount which they can consume without impoverishing themselves. Following out this idea, it would seem that we ought to define a man's income as the maximum value which he can consume during a week, and still expect to be as well off at the end of the week. . . . Remembering that the practical purpose of income is to serve as a guide for prudent conduct, I think it is fairly clear that this is what the central meaning should be.[10]

These comments upon the purpose and nature of income calculations make an appeal to common sense. However, though the idea does not seem to be a complicated

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[7] John B. Canning, *The Economics of Accountancy* (New York: Ronald Press, 1929), p. 160.

[8] *Ibid.*, pp. 196–197.

[9] J. R. Hicks, *Value and Capital* (Oxford: Clarendon Press, 1939), p. 171.

[10] *Ibid.*, p. 172.

one, there are practical difficulties, as Hicks pointed out, in even approximating the "central meaning" under many conditions which prevail in a dynamic society. One of the most trying conditions to handle, even on a conceptual basis, is the case in which prices are expected to change. For this case it is necessary to find real individual income instead of simply money income, and the question of an appropriate price index to use is only one of the several formidable logical difficulties which Hicks sees standing in the way of getting even a reasonable approximation to real individual income. In other words, with as simple a concept of individual income as Hicks has adopted, the concept of a real individual income becomes unmanageable when the phenomenon of price level change is introduced. The Hicks statement is this:

> By considering the approximations to this criterion, we have come to see how very complex it is, how unattractive it looks when subjected to detailed analysis. We may now allow a doubt to escape us whether it does, in the last resort, stand up to analysis at all, whether we have not been chasing a will-o'-the-wisp.[11]

Anyone who would undertake to make price level adjustments on financial statements and claim that real individual income had thereby been reasonably approximated should certainly have been put on notice by these statements of Hicks that a thorough examination of the methodology being used was in order. No such examination of methodology has occurred; in fact, there is little if any evidence that American accountants are aware of the challenge.

The doubt that Hicks expressed concerning the usefulness of the concept of individual income (he was not questioning the appropriateness of the "central meaning") "for any analysis which aims at logical precision" does not mean that a concept of social income does not or should not play "an important part in social statistics, and in welfare economics."

> For that purpose, it is not necessary to have an exact definition of income; something quite rough, suitable to a rough practical precept, will do quite well.[12]

Social income is derived basically out of the aggregate of the incomes *ex post* for all the individuals in the community. Income *ex post* is the difference between the capital value of an individual's property at the beginning and at the end of a period, which makes it a magnitude which is obtained by a process quite familiar to accountants. From the aggregate of individual incomes *ex post* (which Hicks refers to as "an objective magnitude") the effect of variations in prices is removed and this leaves Social Income *ex post.*

> He must take his objective magnitude, the Social Income *ex post*, and proceed to adjust it, in some way that seems plausible or reasonable, for those changes in capital values which look as if they have had the character of windfalls. This sort of estimation is normal statistical procedure, and on its own ground it is wholly justified. But it can only result in a statistical estimate; by its very nature, it is not the measurement of an economic quantity.[13]

Precise statement of the Hicksian concepts is not necessary for this paper. The purpose of the review of the concepts and procedures has been to indicate that it is the view of Hicks that, while it is not possible in a dynamic economy to calculate (or define) real income for an individual, it is possible to obtain reasonably satisfactory figures for social income of a dynamic economy. To do this individual incomes *ex post* are aggregated, corrections are made for price changes that have occurred, and other adjustments made "in some way that seems plausible or reasonable"; there is, however, no hint or suggestion that the same techniques can be applied to each of

[11] *Ibid.*, p. 176.

[12] *Ibid.*, pp. 180–181.

[13] *Ibid.*, pp. 179–180.

the individual incomes *ex post* to arrive at a real income figure for each individual.

The delineation of the uses of the word "income" in accounting, economics, and related fields was the announced purpose of the Study Group on Business Income, organized in 1948 and numbering as members, prominent persons drawn from many diverse fields, but particularly from economics and accounting. One paper prepared at the request of the Study Group, titled "Income Measurement in a Dynamic Economy," was written by Mr. Sidney S. Alexander, formerly Assistant Professor of Economics at Harvard University. This paper generalized and extended the Hicks "central meaning" of income as follows:

> A year's income is, fundamentally, the amount of wealth that a person, real or corporate, can dispose of over the course of the year and remain as well off at the end of the year as at the beginning.[14]

In particular, the Alexander study developed with great care the concept of income of the economist under the Hicksian model and then compared it with the accounting concept of income. It is a very excellent example of what can be done if an honest effort is made to reconcile the purposes and points of view of these two studies which have much in common in subject matter. For example, not once did Mr. Alexander make the statement that accounting income (i.e., the conventional statements based upon original cost) was misleading, or embodied unrealistic assumptions. He did, however, conclude that economic income (if one could find it), rather than accounting income, was what was needed for some important business decisions. The Alexander study was published in 1950, but Supplementary Statement No. 2 shows no evidence that the Committee saw anything in the study that was relevant to the problem there under consideration. The only reference of any consequence in accounting literature to the Alexander monograph is the fairly incidental mention it received when the four volumes representing the work of the Study Group on Business Income were reviewed in the ACCOUNTING REVIEW of July, 1952.[15]

Fundamentally, in Alexander's view, "the problem of measuring income is inseparable from the problem of measuring changes in the value of equity or capital," but it must be recognized that the equity change referred to is not a "books of account" equity but rather one obtained from "the valuation of assets and liabilities at the beginning and end of the period."[16] Presumably in a static economy the equity calculation from the accounting and from the economic point of view would be the same, and in such an economy income could be measured from the "operating profit approach." The operating profit approach "proceeds from a matching of costs against revenues or against products of a specified operation," and

> . . . the actual practice of accountants and businessmen follows fairly closely the operating profit approach in such a way as to get results markedly different from those that would be obtained from the equity approach if equity were independently revalued annually.

What Alexander calls the equity change approach to income

> is considerably broader than the operating profit approach in that operating profit is merely one, although usually the most important, of the components of the change in equity. That is, the change in equity over any period is the sum of operating profit plus net changes in assets or liabilities not entering into the cost or revenues associated with the operation selected as the point of measurement of operating profit.[17]

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[14] In *Five Monographs on Business Income* (New York: Study Group on Business Income of the American Institute of Accountants, 1950), p. 1.

[15] By Professor George Husband, pp. 399–404.

[16] "Income Measurement in a Dynamic Economy," pp. 15–16.

[17] *Ibid.*, p. 17.

In a dynamic economy there are "accretions and losses which do not come in via revenues and costs," and this is the fundamental reason for concluding that economic income cannot be measured without resort to the equity change approach.[18]

The "accretions and losses which do not come in via revenues and costs" are changes in the values of the various capital assets possessed, and changes in the going value of the business entity itself. The changes in the values of assets during a year may be due to change in expectations of future receipts, to change in the rate of interest, or to change in the price level. Since the equity of a corporation is almost never sold for the book value of its (net) assets as above indicated, this is evidence of going concern value for the corporation; and the extent to which there has been a change in going concern value is an additional element to be reckoned as income. In sum,

> Accountant's income then differs from economic income in two important respects: it excludes gain or loss on going value and it excludes gain or loss on those tangible assets not entering directly or indirectly into the current year's sales.[19]

The argument that the equity approach to income measurement is valid is the very practical one that in purchase and sale (the acquisition or disposal of equity) of a corporation it is future income prospects (which are allowed for fully in the concept of economic income) that form the basis for the transaction. Alexander summarizes the evidence on the point in this manner:

> The accountants grant that the capitalized earning power is the only proper basis for valuing equity for purchase or sale and the courts apparently have also come to accept this view. . . .[20]
>
> When any decision has to be made on the basis of a corporation's income, it will always be wiser for the decision maker to base his judgment on the best estimate of economic income he can make, however subjective that judgment may be, rather than to rely on the perfectly objective measure of income based on historical cost, which is irrelevant except as an approximation to economic income or as a subject for idle curiosity. It is better to act on the subjective evaluation of the relevant factors than on a perfectly objective measure of irrelevant factors. . . .[21]

As for the computation of real income of a corporation, Alexander remarks that "it is necessary to put both year-end and year-beginning equity into terms of dollars of equal purchasing power,"[22] but no particular use seems to be made of the computation. Instead, Alexander suggests that the money income figure (not the accounting net income) might be broken down into the components of pure sales profit and mixed sales profit, and that the latter might be stated in terms of contemporaneous dollars (called contemporaneous sales profit) in order to afford "an adequate basis of inter-firm comparison."[23] This entire excursion into the realm of real income calculations for a corporation seems to have been undertaken primarily to deal conceptually with a view sometimes expressed and with which Alexander differed, stating that

> primarily it is not the task of management to buy and sell well; it is merely the task of business management to produce as much as it can whenever there exists an advantageous difference between cost and selling price. With this view I must take strong issue. It is an important responsibility of management to make the value of present owner's equity as large as possible by whatever legitimate means is open to management. . . . To use a measure of business profits which completely disregards a management's success or failure in buying and selling is to neglect a most important part of management's activity and responsibility.[24]

And on the question of which of the elements of economic income it is that man-

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[18] *Ibid.*, p. 199.
[19] *Ibid.*, p. 38.
[20] *Ibid.*, p. 40.
[21] *Ibid.*, p. 60.
[22] *Ibid.*, p. 75.
[23] *Ibid.*, p. 90.
[24] *Ibid.*, p. 89.

agement tries to maximize, this is the Alexander answer:

There may well be an advantage for presentational purposes in separating out the two components of mixed sales profit, the pure sales profit on the one hand, and the price gain on goods sold on the other. But both components must be considered in evaluating the success of a corporation in a given year. . . . Management decisions should aim at the maximization of mixed profits from sales and not at either of its components exclusively. Such maximization must always, of course, be subject to an adjustment for the effect of any decision on future profits, which comes around to saying that management must in the end try to maximize mixed economic income.[25]

There is certainly nothing in this development that suggests that Alexander even contemplated price level adjustments of accounting statements as a means of arriving at the real income of the corporation.

The functions of accounting income, even in a period of rising price levels, were listed by Alexander as two in number. There is, first, the fact that customarily there are many contractual relations stated in money terms which give no heed to price level changes:

Under the trust fund theory of a corporation, that the creditors are entitled to protection against reducing the value of owner's equity below a stated amount, it is appropriate to use a money measure rather than a real measure of capital. . . .

For the purposes of taxation there is some justification for the use of a money measure. . . .[26] . . . But in an economy in which many contractual relations are expressed in money terms certain inequities would be introduced by measuring business income in real terms while government obligations, corporate bonds, and bank deposits were still fixed in money terms.[27]

In the second place, accounting statements prepared in the conventional manner provide some of the elements that are usable when economic income is the figure which is important:

On the other hand, you cannot get away from the fact that what is wanted in accounting are objective measures, and therefore some way or other the gap must be bridged between the objective measure, which most accountants will agree is what the accountant should limit himself to, and the subjective measure, which is really the final desire.

In many ways I suggest that accountants must direct their attention to so presenting their objective measures as to give the best basis to the man we call the business man to make his subjective projection, which is the real and final measure of capital and income, the real and final measure of capital being what it is worth to somebody; whatever the books show is merely perhaps an aid to someone's forming a judgment of what it is worth to him.[28]

In Alexander's eyes, then, the accountant is not accused of presenting "misleading" financial statements; the statements give useful results, this irrespective of price level changes.

It is hard to explain why the Alexander monograph, now four years since it was published, has had no noticeable impact upon the literature of accounting in the area of price level adjustments. Perhaps the George O. May criticism has unduly deterred accountants from giving it the attention it would seem to deserve. Said Mr. May in a discussion of the paper:

. . . I would suggest, as our purpose is to try to evolve some concept that is capable of implementation by accounting methods, and Mr. Hicks has rejected it for his purpose, *a fortiori* it is no good to us as a practical proposition.

I think this is what you have proved. There is an economic concept held by a very respectable body of opinion that is of no practical use to this particular group. So far, that is one thing we have demonstrated that I think is valuable and we can go on from there. That is my feeling. We can get back to the concepts that are used for national income, which I think are much closer to our point of view for our own determination, rather than your remote one.[29]

[25] *Ibid.*, pp. 89–90.
[26] *Ibid.*, p. 78.
[27] *Ibid.*, pp. 94–95.
[28] *Ibid.*, p. 203.
[29] *Ibid.*, p. 205.

It is unfortunate that Mr. May did not understand that the basis on which Mr. Hicks had rejected the income concept was only that it was not "an instrument of precision" in the analysis of a dynamic economy; it is even more unfortunate that in his preoccupation "to evolve some concept that is capable of implementation by accounting methods," Mr. May did not recognize the implicit arguments of both Mr. Hicks and Mr. Alexander, that it is conceptually impossible to adjust at the enterprise level the accounting income to reflect real (economic) income *for the enterprise*. And it is most unfortunate that the emphasis upon a "practical proposition" took the form it did; conceptual models, even those which make use of ideas which cannot be given precise values, can give "practical" results by pointing the direction in which progress can be made and by warning against improper procedures. Thus Alexander repeatedly warned that a concept of economic income was useful even though it could not be objectively determined.

> But in a dynamic world subject to unforeseen changes of prices and business conditions, it is not possible to avoid guesswork in the determination of income. To the extent that the accountant can eliminate guesses, he is substituting something else for income.[30]
>
> A definition which requires knowledge of all future circumstances is obviously of little practical use. It is presented here for conceptual clarification only.[30]
>
> There is no escape from the necessity of using expected receipts as the basis of a sound evaluation of a corporation. Any attempt to avoid the subjective nature of such expectations through the exclusive use of some objective measure of profit on past operations is likely to do more harm than benefit to anyone relying on the valuation. A valuation must be based on a judgment of the future, it cannot be both sound and objective at the same time in a world of uncertainty.[30]

Economic income appears then to be a concept incapable of precise measurement or expression in money terms. It is impossible, either as a practical proposition or on the basis of a conceptual model, to begin with accounting income and by means of price level adjustments wind up with something which could reasonably approximate economic income. This appears to be an assignment which accountants should not have set for themselves.

It would, incidentally, be interesting indeed to see the Alexander monograph rewritten by an accountant—but one who did not subscribe to the fetish of price level adjustments for financial statements.

II

The fact that it has been established that it is impossible to convert the reported accounting income for an individual enterprise into something that can be called economic income for that enterprise does not necessarily dispose of price level adjustments of financial statements as nonsense. Supplementary Statement No. 2, which has been assumed to be an authoritative statement of the proposition for such price level adjustments, does not make any such explicit claim of intention to convert accounting income into economic income. It still remains, therefore, to examine the specific claims made for price level adjustments and to render judgment on their validity.

Supplementary Statement No. 2 begins with stating two well-recognized propositions: the value of the dollar has decreased considerably since 1945, and conventional accounting statements do not specifically recognize the fact of that decrease. A warning is given that associating these statements in this manner results in implications not universally held by accountants, for the discussion is in terms of what "some accountants" contend. Probably one of the key statements is this:

> Some accountants contend that the principal significance of dollars lies not in their number but in their purchasing power.

[30] *Ibid.*, pp. 7, 29, 88.

Upon analysis one finds that the body of Supplementary Statement No. 2 is occupied with presenting the views of those accountants who believe that financial statements should somehow reflect price level changes, and with setting forth some basic features of a methodology appropriate to such an objective. The issue of price level adjustments is not debated in Supplementary Statement No. 2; rather, it insinuates that some terrible truths which are hidden from the view of the more or less casual reader of financial statements and accounting reports by the price level changes will become clearly outlined in adjusted statements.

An interesting sidelight upon the direction in which Supplementary Statement No. 2 is pointed is revealed by juxtaposing the Committee's summary of deficiencies of conventional accounting as viewed by "some accountants" and Henry W. Sweeney's list of "Where ordinary accounting goes wrong."

Committee: Experience amply demonstrates that money as a standard of value is an unstable variable.	Sweeney: Ordinary accounting procedure is not suitable for indicating whether an enterprise has approached nearer the usual goal of economic activity, *viz.*, increase in the general purchasing power of the owner's investment in the enterprise.[31]
Committee: In many cases the balance sheet represents the assembly of basically non-additive amounts.	Sweeney: Ordinary accounting procedure combines figures that are not expressed in the same kind of measuring unit, thus violating the basic mathematical axiom that "Like added to like gives like."[31]
Committee: Income calculations are distorted by the failure to place all amounts on a uniform dollar basis.	Sweeney: Figures on the books and on the accounting statements fail to include all the helpful information that they can easily include. Such information that is missing consists of the gains and losses resulting from changes in the value of money.[31]

The degree of coincidence between the two lists is indeed striking and it further indicates that the goal of Supplementary Statement No. 2 is that of Sweeney, i.e., of making financial statements speak in terms of purchasing power. The project is demonstrably not a new one; this time the considerable prestige of an important committee of the American Accounting Association has been enlisted in the undertaking to encourage "experiment" by the accounting profession with price level adjustments. Inasmuch as Sweeney was never able to convince accountants that it would be wise to adopt his procedure, it is pertinent to inquire wherein the case is now made persuasive.[32]

The Committee reported that it posed itself three questions on the desirability of giving explicit recognition to changes in the value of the dollar and the best means of measuring those variations and of disclosing the results thereof. Supplementary Statement No. 2 contains the six answer-

[31] Henry Sweeney, *Stabilized Accounting*, pp. 24, 24, 15.

[32] It might be pointed out that the President of the American Accounting Association in 1950, Professor Perry Mason, criticized the 1948 revision of *Accounting Concepts and Standards* for insufficient recognition of "the effect of inflation upon accounting data." He wrote: "It is particularly unfortunate that this failure to recognize the significance of current costs should occur in a statement issued by an organization which is supposed to be predominantly academic in its membership and in its approach to accounting problems. . . . The flat rejection, except for a weak permissive statement in the Financial Statements section, of anything but original cost makes the statement vulnerable to legitimate criticism, ignores the fact that such a position will not generally be accepted when price movements are even as pronounced as they have been recently, and fails to take the opportunity of assuming a position of leadership as to sound and reasonable alternatives." Accounting Review, April, 1950, pp. 133–134.

conclusions accompanied by some discussion. On the question of desirability, it appears that the "materiality" of the price level rise since 1945 was convincing, particularly since the Sweeney device of restating the primary financial statements in purchasing power terms was rejected. It is more difficult to state the Committee conclusions and recommendations on the other questions as compactly; the following five propositions do seem to summarize fairly the salient features of the price level adjusting procedure envisioned.

1. Financial statements submitted to stockholders shall "continue to reflect historical dollar costs." However, such statements should be accompanied by "comprehensive supplementary statements which present the effects of the fluctuation in the value of the dollar upon net income and upon financial position." Furthermore, such supplementary statements "should be reconciled in detail with the primary statements . . ." and "should be accompanied by comments and explanations clearly setting forth the implications, uses, and limitations of the adjusted data."

2. This scheme of supplementary schedules is but "the orderly evolution of accounting" which "now requires, as an extension of present practices, the reflection in financial statements of all items of revenue and cost on a 'common dollar basis.'" By implication, therefore, it is the accountant (not an economist) who would prepare these supplementary statements. However, "during the period of development (or of experimentation, whichever it may prove to be), such statements need not be covered by the independent accountant's opinion, although he might assist in their preparation."

3. "Since the supplementary statements are intended to restate historical costs to reflect changes in the value of the dollar and are not concerned with changes in the value of specific assets, a general price level index should be used." The justification for preparing the supplementary statements "to reflect changes in the value of the dollar" is that the bias in financial statements and reports due to price level change is thereby eliminated. There is "an educational purpose" to these supplementary statements, and the whole exercise will result in "a better understanding of our economic environment" and "the establishment of more sound business relationships."

4. Though the primary intent is to state all items of revenue and cost on a "common dollar" basis, all items in the balance sheet and the profit and loss statements are to be adjusted. Such all-inclusive statement presentation is required by consistency and the logical necessity of recognizing that there is a "'net balance of fixed-dollar items' (assets fixed in dollar amount minus claims fixed in dollar amount)."

5. "Financial statement data expressed in uniform 'current dollars' would seem to be useful for the following purposes:

"(1) The appraisal of managerial effectiveness in terms of the preservation of the current dollar equivalent of the capital invested in the business and not merely its initial dollar amount;
"(2) The analysis of earning power in terms of the current economic backdrop;
"(3) The determination and justification of sound wage policies; negotiations with labor unions;
"(4) The determination by government of long-range policies with respect to 'control' of the economy through monetary policy, price regulation, limitation of profits, taxation, etc.;
"(5) The creation of an informed public opinion with respect to profits, prices, wages, etc., and the effect of inflation (or deflation) upon financial relationships generally;
"(6) The determination of managerial policies with respect to pricing, credit, dividends, expansion, and the like."

With the perfection of these supplementary reports the accountant will truly assume a new role in society, for he will now submit statements which all segments of the economy can use without adjustment—stockholder, economist, labor union, government, and above all, management. His statements will dramatize to all the changes that have taken place in the value of the dollar and by so doing will have removed at least that cause of strife in society that arises out of an inadequate understanding of an economic environment beset by a depreciating dollar. The supplementary statements will be effective because they will be accompanied by "comments and explanations" which will clearly set forth "the implications, uses,

and limitations" of these supplementary statements. A jolt to these high hopes occurs, however, with the reference to "the period of development (or of experimentation, whichever it may be)."

It has often been asserted that the final test of accounting procedure and report is utilitarian. The list of purposes quoted above for which the adjusted statements "would seem to be useful" are suspiciously vague. Nor does one get any aid in putting substantial content into these purposes from the discussion in the text of Supplementary Statement No. 2 or from the explanatory comments of two committee members.[33] There appears to be no recourse other than to analyze the listed purposes in the light of the entire proposal, supplemented at points by quotations from an article by Willard J. Graham, the Chairman of the promulgating committee.

Purpose (1) and purpose (6) would seem to be simply two sides of the same shield. Consider first the aid to management that would be afforded by statements expressed in "uniform current dollars," particularly in the area of pricing policy. Professor Graham put the case as follows:

> ... Insofar as there is any relationship between selling prices and costs, it tends to be between selling prices and *current* costs. For unregulated business, then, the accountant's choice between current cost and original cost has little or no effect on selling prices. However, his choice does affect the determination, reporting, and interpretation of income, and that is the subject of this discussion.[34]

If by current cost Professor Graham means the cost on the present (current) market that would have been incurred in obtaining the factors being used in production, there can be no argument with the proposition he stated. The item of cost most often alluded to as being on a non-current dollar basis in accounting statements is depreciation. To restate, by means of a multiple representing the rise in the price level, the investment in fixed assets on a "uniform current dollar" basis would necessarily result in an increase in the depreciation item. At the same time that one agrees with Professor Graham that in unregulated business it makes no difference on selling prices which cost the accountant records, he is also agreeing that adjusted statements are irrelevant for "the determination of managerial policies with respect to pricing." In other words, for Professor Graham, current costs on financial statements are desired for the effect they produce on operating profits, not for pricing policy.

Supplementary Statement No. 2 proposes that the conversion of an investment in fixed assets to a "uniform current dollar" basis be accomplished by means of a general price index. The question is whether depreciation calculated on this "uniform current dollar" basis is properly called a "current cost" in the sense in which Professor Graham was using the term. The concept of current cost has, as a matter of fact, a quite important function to perform even in periods when the price level is reasonably stable, such as, for example, reflecting the impact of obsolescence, both actual and prospective, due to technological progress and to the change in the demand for the good. Technological progress and changes in consumption patterns are both likely to be significant forces in industry at the very time that price levels are rising, their net effect being to offset the effect of the rising price level. Whenever this offset has occurred, the current dollar restatement of the fixed asset investment results in an excessive portion of the reported net profits being elimi-

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[33] Thomas M. Hill, "An Analysis of Supplementary Statement No. 2," ACCOUNTING REVIEW, January, 1952, pp. 16–24; Maurice Stans, "Accounting for Price Level Changes," *Journal of Accountancy*, January, 1952, pp. 52–59.

[34] Willard J. Graham, "Changing Price Levels and the Determination, Reporting, and Interpretation of Income," ACCOUNTING REVIEW, January, 1949, p. 15.

nated as due to price level change. The proposal for a current dollar restatement of fixed assets turns out to produce a fickle adjustment, a reasonably satisfactory one when technological progress has been relatively slight and becoming more and more unsatisfactory as technological progress is more far-reaching. It is reasonably clear that technological progress characterizes American industry and so the procedure cannot be justified as doing a reasonably adequate job "in the large." The segregation and identification of the impact of price level change upon the financial statements of the typical business enterprise is too complicated to be accomplished by the mere device of applying an appropriate general price level index to any or every item on the financial statements. And since technological progress does not occur evenly, the degree of error introduced by the proposed adjustment device would seem to vary over a very wide range.

It is also suggested that adjusted financial statements will be useful for determining proper dividend policy and expansion policy, the implication often being that large reported net profits build up an irresistible pressure for dividends to the detriment of the firm, since funds needed either for replacement of assets or expansion of facilities will instead have been paid out to stockholders. It follows, then, that to reduce reported net profits, other things being equal, would leave more funds available for expansion. But do adjusted statements provide the climate in which expansion will be encouraged, and especially when the point above is recalled that the adjusted statements tend to overdeflate? It will readily be granted that it is future expectations that furnish the guide for expansion, but those future expectations will ordinarily be based on evidence of substantial present profits. Thus, Professor Jones's widely quoted and publicized study of nine steel companies[35] in a period which saw substantial inflation, to be discussed more fully in the following section, really strongly suggested that steel was a decadent industry which was slowly but inexorably being liquidated through payments of dividends and income and excess profits taxes. That the management of the steel industry did not draw such a conclusion on the outlook for the industry is indeed fortunate. It would seem to be correct to say that in the steel industry hindsight shows the unadjusted financial statements a better guide to expansion than the adjusted statements.

How much can or should be paid in dividends is partly a matter of law and partly a matter of how best the future prospects of the firm can be furthered; how much should be spent for future expansion depends on future expectations and the risks attendant thereupon. The most that accounting reports can do is to suggest, on the basis of past attainments, where future expansion might occur. There is nothing conclusive about the evidence, for management must still evaluate it in the light of all the prospects for the future. Within the past decade the expectations of management in, say, harness and windmill manufacturing, might well have suggested quite different dividend and expansion policies as compared to steel and chemicals.

The proposition listed as purpose (1)—"the appraisal of managerial effectiveness in terms of the preservation of the current dollar equivalent of the capital invested in the business and not merely its initial dollar amount"—implies that the discretion of management in utilizing the disposable funds of the enterprise is limited in one important sense, *viz.*, that the reservoir of purchasing power represented by the investment in the firm must in any case be preserved undiminished. The general prin-

[35] Ralph C. Jones, "The Effect of Inflation on Capital and Profits: The Record of Nine Steel Companies," *Journal of Accountancy*, January, 1949, pp. 9–27.

ciple of this reservoir is stated by Professor Hill as follows:

> Management has a responsibility for preserving and enhancing the basic invested values. The manner in which it acquits itself of its stewardship obligation is best accounted for, and best judged, where the economic effects of changes in dollar significance are clearly and comprehensively set forth.[36]

A reservoir no more specifically defined than that it consists of "basic invested values" to be preserved and enhanced is indeed a hazy concept. The reference to a "stewardship obligation" has slightly more meaning, for in going concerns the stewardship obligation is not fully discharged until a report of operations has been made in which the distinction between capital and income has been rigorously and meticulously maintained. It has already been noted that Supplementary Statement No. 2 is preoccupied with reckoning net income only after the charges for "capital consumed" have been adjusted to reflect what those charges would have been had the fixed asset investment been stated in "uniform current dollars"; this fixed asset investment restated in these uniform current dollars appears to be the reservoir of purchasing power which is to be preserved. It will be recalled, however, that the adjustment of reported accounting net income in this manner over-deflated the net income. Moreover, the principle of a reservoir of purchasing power that must be preserved undiminished leads to the rather curious and untenable conclusion that management is to some extent denied the right or the responsibility of contracting the size of the firm if that would seem to be wise in the light of business prospects. The comment of Mr. A. R. Prest, an English accountant, on this point is pertinent.

> Nor can it be argued with great conviction that the interests of shareholders are best served by a measure of capital consumption which preserves income permanently intact, for even though it may be true that an individual may so wish to arrange his affairs as to preserve income intact *for his own lifetime*, that is no justification for assuming that the firm should act so as to preserve its income at the same level forever. In fact, it is very hard to see any real reason for supporting this latter idea at all, for although we may agree that the firm today is a continuing organism, there the analogy with society as a whole ends. Whereas we may agree and hope that society as a whole will as least preserve its stock of physical assets intact from one generation to another, to argue that every individual firm must do so is surely unwarranted.[37]

In sum, then, the concept put forth in Supplementary Statement No. 2, that there is a reservoir of purchasing power which must be preserved undiminished by an "effective" management, is one that must be rejected for it embodies a "modification of accounting postulates" (as Professor Hill characterized it) that represents an unsound management principle.

To recapitulate the development of this section thus far, the adjustment of net income which is proposed is basically unsound because at bottom the adjustment procedure rests upon a confusion of terminology. Current costs (interpreted as opportunity costs, a proper basis for an inquiry of this sort) are spuriously equated to historical investment costs restated in terms of current dollars. This equating is appropriate only if obsolescence, physical or functional, has not occurred or is not in prospect. Since the fact of obsolescence typifies American industry generally, the adjustment procedure results in adjusted charges against revenue, which exceed the properly determined current costs. The amount of this overstatement of costs may vary over a wide range, making it hazardous to use these adjusted statements. It is

[36] "An Analysis of Supplementary Statement No. 2," Accounting Review, January, 1952, p. 23.

[37] "Replacement Cost Depreciation," Accounting Research, July, 1950, pp. 385–402. Reprinted in Mary E. Murphy, *Selected Readings in Accounting and Auditing* (New York: Prentice-Hall, Inc., 1952), p. 276. This article uses some of the Hicksian concepts.

not clear how far the results of the past (the subject of accounting reports) should color the judgment of management in its projection of future expectations; certain it is that the adjusted statements with an undeterminable amount of error in them could hardly be expected to be useful. As a matter of fact, the over-deflated net income may actually put a damper on both expansion and replacement and so affect materially the form in which the contemplated reservoir of purchasing power would be maintained. Not only are prejudiced statements of no value in judging the effectiveness of management, but the very concept of a reservoir of purchasing power to be preserved runs counter to correct principles of management.

In the review made earlier of the salient features of the system of adjusted financial reports proposed by Supplementary Statement No. 2, attention was directed to the very important place that seemed to be assigned to demonstrations by means of accounting reports of the extent to which the value of the dollar had changed in these recent years. It is surprising to find accounting reports assigned this role by the committee, for this certainly extends the area in which accounting reports have conventionally been held to be appropriate. Of the six listed purposes for which it was said the adjusted financial data "would seem to be useful," four seem to be slanted in the direction of "an educational purpose." The "educational purpose," it will be recalled, was aimed toward creating "a better understanding of the economic environment" and "the establishment of more sound business relationships." The purposes which seem to fit well into the general classification of serving "an educational purpose" are these:

(2) The analysis of earning power in terms of current economic backdrop;
(3) The determination and justification of sound wage policies; negotiations with labor unions;
(4) The determination by government of long-range policies with respect to "control" of the economy through monetary policy, price regulation, limitation of profits, taxation, etc.;
(5) The creation of an informed public opinion with respect to profits, prices, wages, etc., and the effect of inflation (or deflation) upon financial relationships generally.

A doubt arises whether these are valid ends for adjusted financial statements. If the adjusted data do not provide management with data reliable for the exercise of its appropriate functions (insofar as accounting data can properly do this) it is difficult to see how these same adjusted data can be said to serve an educational purpose. Even more fundamental, is it not an exaggerated claim that financial statements, whether adjusted or not, perform such a broad social function as measurably enhancing the understanding of the economic environment or providing the means by which the justice of the distributive shares can be evaluated or improved? Financial statements are necessarily enterprise-centered and are reports reflecting past efforts and accomplishments. It should not be claimed that financial statements provide anything but the most incidental sort of evidence on sound wage policy, sound monetary policy, or any of the other listed problems.

The relevance of the adjusted financial statements for the purposes listed is not established either in the text of Supplementary Statement No. 2 or in the explanatory comments of the two committee members. A possible clue to what was intended is furnished by Professor Graham's article, for the topics he discussed there bear a striking resemblance to the enumerated list of purposes. In this article he referred to the "accountants and others" who held "a feeling that accountants should 'do something' about the unreality of income figures based on original costs." It can be inferred that the precept, to "do

something," was aimed at the easy but unwarranted generalization that corporate profits were unnecessarily large. Translated into a program of action, this required that a system be devised for "correcting" these reported profits and that the corrected figures be shown to have a very wide range of application and interest. The Graham article did not spell out a complete system for making price level corrections, but it did establish the proposition that price level changes and the accompanying impact upon accounting income were matters of widespread importance. In general, the conclusion was that profits, properly viewed, were really not excessive at all and that it was dangerous for the economy for it to be widely believed otherwise. It was never really clearly established what the relationship was between the corrected profits of the individual enterprise and the determination of proper policy for the economy.

On the matter of whether the present level of profits might be expected to continue ("the analysis of earning power in terms of the current economic backdrop"), Professor Graham observed that "Income, as ordinarily computed and reported, arises primarily from two related but to some extent independent sources." The sources are identified as management profit and price profit, the latter being "not profit at all, but merely a restatement of capital in terms of different monetary units."[38] Both stockholders and employees need to recognize this difference of source of profits.

And price profits are not a sound basis for predicting future profits; they will not recur without continued price advances and, if recognized, they will be cancelled by price losses when prices decline. . . . An employee may study the income statement to determine "whether this is a good place for him to work." This depends upon whether the business is likely to continue operations at a high and profitable level, and what the chances are for regular employment at satisfactory wages.[39]

Sound wage policies could be determined and negotiations with labor unions properly carried on, in the opinion of Professor Graham, by consulting financial statements which did not contain these "unreal income figures" based on original costs.

But an honest appraisal of ability to pay must make allowance for the necessity of maintaining ***physical*** capital, and not just the recovery of ***dollar*** capital. . . . Can we blame the leaders of organized labor for disbelieving management's protestations about the unreality of reported profits when certified income statements ***support*** the union's accusations of "unconscionably excessive corporate profits" for 1946, for 1947, and, unless we do something about it now, for 1948?[40]

Long range government policy in numerous areas is vitally affected by the amount of national income which is estimated. Professor Graham asks:

Why should accountants present income figures that must be "adjusted" before they are useful for such an important purpose as determination of national economic policy?[41]

Professor Graham was greatly concerned about the implications for price and wage policy of a computation that showed that for 1947 total corporate income amounted to "about 10%" on corporate net worth. To put this reported rate of return in proper perspective, he reduced reported incomes by the amount of the estimated price profits, and he increased corporate net worth to reflect the change that had occurred in price levels. The resultant rate of return was less than 5%, a dramatic demonstration that inflation did affect "financial relationships generally." His conclusion was:

It would seem that the charge so frequently heard

[38] "Changing Price Levels and the Determination, Reporting, and Interpretation of Income," ACCOUNTING REVIEW, January, 1949, pp. 15–16.

[39] *Ibid.*, p. 19.
[40] *Ibid.*, p. 20.
[41] *Ibid.*, p. 20.

—that corporations are making excessive profits —is hardly justified.[42]

The last two of the listed purposes considered above, and possibly the one preceding them, seem basically to imply that corrections of the sort made to the aggregate of corporate incomes in the course of national income calculations might better be made directly by each corporation on its own income statement, thus making it possible to obtain this portion of the national income figure by a simple process of summation. This suggestion overlooks the fact that the adjustments to obtain national income are designed to give quantitative expression to the change in the well-being of the economy, whereas these same adjustments are not convincingly applicable to giving quantitative expression to the change in the well-being of the individual business enterprise. How to quantify the change in the well-being of the individual enterprise in a dynamic economy is a difficult problem; it will be recalled that Mr. Hicks rejected an income calculation for the purpose.

Upon reflection, it also appears that these four listed purposes, for which adjusted financial data were said to be useful, were really something quite different. The compelling reason for the issuance of Supplementary Statement No. 2 seems really to have been the deep (and correct) conviction that a comparison of income figures of recent years with those of prior years gave a greatly exaggerated impression of the relative well-being of business and that the deflation that was accomplished by means of adjusted statements eliminated the appearance of comparative opulence. Howard Greer (listed as one of the consultants of the committee) seems to have given a highly reasonable explanation of the pressure for perspective in interpreting income figures.

What many business men and accountants really fear is not that their statements will distort the facts, but that they will give unscrupulous readers of the statement an opportunity to derive or spread imperfect conceptions of what is going on.

Business men would welcome some device introduced into financial statements which will produce a result that cannot be used against them in discussions of prices, wage rates, taxes, or profit. They would like to have the statements constitute both a measurement and an interpretation—the interpretation being favorable to the economic attitudes which they find inescapable.[43]

Those four purposes listed in Supplementary Statement No. 2 as areas in which adjusted financial statements might serve an educational purpose might well be rephrased somewhat as follows as reflective of the appropriate interpretation of recent reported incomes.

(2) To the extent that profit margins have widened because goods have been sold on a higher market than prevailed when they were purchased, there is a windfall ("not profit at all");

(3) Ability to absorb a wage rise and the company still be as well off as it was historically cannot be reckoned simply by subtracting the amount of the increased wage bill from the previous year's profits. A whole new set of conditions prevails, which is not adequately disclosed from any previous year's financial statements;

(4) It is hazardous to leave adjustments of financial statements to compilers of national income; in any case, "the government" is likely to be under pressure to "do something" about the unadjusted (actual reported) incomes, *e.g.*, enact excess profits taxes;

(5) It is a very difficult task which faces management to pay more wages and more taxes, pay more generous dividends suggested by the improved earnings reports, and to keep the physical plant up-to-date.

The procedure recommended by Supplementary Statement No. 2, the presentation of adjusted financial statements,

[42] *Ibid.*, p. 17.

[43] "Depreciation and the Price Level," ACCOUNTING REVIEW, April, 1948, p. 130.

really provides no interpretation at all of reported incomes. At the same time that these adjusted financial statements did accomplish one of their intended purposes, the reduction of reported income, they created two erroneous impressions. One is that the problem of quantifying change in well-being of an enterprise has been solved, the other is that such quantification is what should be expected in good financial statement preparation. The committee would have done well to follow the advice of Howard Greer instead of creating the impression that financial statements should really be expected to provide a basis for judging relative well-being of business enterprises.

> The correct solution of this problem lies in the education of the public in the problems of business economics and the way in which they are affected by fluctuations in money values. This requires not a revision of accounting statements but a thorough-going exposition of their significance as stated.
>
> The business man and the economist must see that the facts are understood, and the politicians and the labor leaders must learn to understand them. It is idle to rely on any supposed gains that may spring from befogging the issue. Manipulation of depreciation charges will merely cast doubt and discredit on the accountant's statements, rather than make them carry conviction to the uninitiated.[44]

The charge that accounting statements are misleading during a period of inflation implies an undefensible concept of the proper function of financial statements.

Two ancillary concepts mentioned in Supplementary Statement No. 2 require passing attention. One is that there is inherent in the fabric of accounting an implicit assumption concerning price levels. The opening sentence of Supplementary Statement No. 2 is this:

> One of the conventions presently underlying corporate accounting is the assumption that fluctuations in the value of money may be ignored.

The explanatory remarks of Professor Hill imply a more extreme assumption, for he refers to "the accountant's fallacious conventional assumption of stability in his unit of measure." The analysis of this paper, supported by the Hicks-Alexander development of the problem of income measurement, is that accounting *per se* needs give no heed to changes in the value of money. This position, however, needs to be reconciled with the limiting case of accounting under conditions of unbridled inflation, as occurred in France and Germany in post-World War I days.

Accounting, as it is conventionally conceived, is inextricably tied in with an exchange economy. The transactions consummated in the business world are typically expressed in a money of account. As Paton and Littleton express it:

> The basic subject matter of accounting is therefore the measured consideration involved in exchange activities. . . .[45]

And accounting principles set out procedures by which transactions which contain no measured consideration can be made to submit to the money calculus for accounting purposes. In short, accounting uses money-price expressions because money is typically the common denominator for all transactions and there is typically no disadvantage to the business firm in holding money balances. In extreme inflation, however, there is hesitancy about accepting (to say nothing of holding) money balances, and for all practical purposes the economy is a barter economy. Inflation is, therefore, a phenomenon to be reckoned with whenever it begins to lessen the effectiveness of operation of the exchange economy. The evidence of that lessened effectiveness lies in a reluctance to conclude transactions which would result in receiving and holding money balances. The authors of the 1948 revision of *Ac-*

[44] *Ibid.*, p. 131.

[45] *An Introduction to Corporate Accounting Standards*, pp. 11–12.

counting Concepts and Standards were therefore correct when they concluded that "price changes during recent years do not afford sufficient justification for a departure from cost." The correct reason was that despite the magnitude of the price rise there was nowhere any evidence that business men hesitated to accept money balances. When the exchange economy, and the concomitant ready acceptance of money balances, ceases to operate freely, then conventional accounting procedures stand in need of revision by reason of inflation; and an extreme inflation is an obstacle to the free functioning of the exchange economy that would require just such an overhaul of accounting procedures.

Supplementary Statement No. 2, in support of the proposition that price level changes of recent years required modification of accounting reports, had also repeated the charges made by "some accountants" that "in many cases the balance sheet represents the assembly of basically non-additive amounts." Henry Sweeney, for example, had claimed that the differing purchasing powers represented by the various money expressions on the balance sheet violated the mathematical principle that like must be added to like. He undertook to make the point by an analogy which he stated as follows:

> To follow the example of a French writer who was pointing out the absurdity of combining figures that were expressed in prewar gold francs with figures that were expressed in depreciated, paper francs, let the different kinds of dollars in this case be looked upon as different kinds of vegetables.
>
> Then the dollar of January 1 may be looked upon as cabbages, the dollars of December 31 as carrots, and the average dollars for the year as little red radishes. Hence, the cash, instead of being 750 dollars, becomes 750 carrots; and the fixed-asset value similarly becomes 500 cabbages. Now if 750 carrots are added to 500 cabbages, the total is what? Obviously there are 1,250 individual items, but also obviously they cannot properly be termed "1,250 carrots" or "1,250 cabbages." Either they must be termed 750 carrots *and* 500 cabbages," or they must be given a less specific name and be termed just "1,250 vegetables."
>
> Similarly, when the dollar is used as the measuring unit, the total assets in this illustration should be called "750 dollars of December 31, 1933 and 500 dollars of January 1, 1933." If on the other hand, the usual meaning of "dollar" is meant to comprise *all kinds* of dollars, just as "vegetable" comprises cabbages, carrots, and little red radishes, there is no particular objection —but also no particular meaning—in referring to the asset total of "1,250 dollars."[46]

"Vegetable dollar accounting," Sweeney thought, could be avoided "by expressing all figures in the price level of the end of the period."[47] In terms of the analogy, that Sweeney abandoned too soon to be convincing, this is tantamount to arguing that a carrot-cabbage-radish conversion ratio was available so that the term vegetables—which had "no particular meaning"—could be avoided and a summation made also. There being no such conversion ratio, Sweeney should have argued that balance sheets were conceptually possible only under conditions of perfectly stable price levels. Since he did continue to make balance sheets, it must be concluded that the whole argument is a specious one and that he did not establish the proposition that a mathematical principle required price level adjustments of financial statements.

III

The preceding analysis suggests that financial statements adjusted for price level change would not be useful for purposes either of guiding management in the exercise of its proper functions or of testing the "effectiveness" of management; and that financial statements, either adjusted or unadjusted, are not the proper base upon which to formulate such important policies as a sound wage policy, a sound

[46] *Stabilized Accounting*, p. 8.
[47] *Ibid.*, p. 43.

tax policy, a sound dividend policy, or a sound expansion policy, primarily because they do not provide a basis upon which to make a sound prediction of future levels of profits. But since financial statements adjusted for price level change have been recommended, the question naturally rises of the form which these reports supplementing the primary statements will take and how the evidence will be presented. An additional suggestion of the Committee might well occasion some dismay by the accountant at the task which confronts him; he must explain the statement as well as prepare it.

(c) Such supplementary statements should be accompanied by comments and explanations clearly setting forth the implications, uses, and limitations of the adjusted data.

This will not be a task easily performed.

Supplementary Statement No. 2 does not make the point as explicitly as it should that the form and content of these adjusted financial statements is still a matter of experiment. The "Summary" section contains the most explicit reference to the experimental nature of the project:

It is the judgment of the Committee, therefore, that the time has come to give adjusted dollar statements a thorough test. . . . A number of such experiments by different corporations in different types of business will undoubtedly be required. Only by means of experimentation can methodology be tested and usefulness proved or disproved.[48]

It turns out that the Committee did not intend to sanction any particular method of making these adjusted statements. According to Professor Hill,

Majority opinion held that the Committee's proper function in this regard was presently limited (1) to offering its considered judgment as to the basic qualifications of an acceptable approach and (2) to attempting to stimulate research and experimentation.[49]

[48] Accounting Review, October, 1951, p. 473.

[49] "An Analysis of Supplementary Statement No. 2," Accounting Review, January, 1952, pp. 18–19.

The Committee did, however, state the "basic qualification of an acceptable approach":

1. "Adjustments made for changes in the value of the dollar should be all-inclusive (i.e., should apply to all statement items). This is held to be essential to full disclosure."

2. "The effects of price fluctuations upon financial reports should be measured in terms of the over-all purchasing power of the dollar—that is, changes in the general price level as measured by a *general* price level."

To contrive a methodology which will at the same time submit to these "basic qualifications" and the results therefrom be susceptible of a *clear* (convincing) explanation of "implications, uses and limitations" would seem to be a big order. It will be an impossible one <u>if</u> the previous analysis has been correct.

Although the Committee did not specify any particular methodology for preparing adjusted statements, it seems altogether likely that the Committee must have considered the study of Professor Ralph Jones, "The Effect of Inflation on Capital and Profits: The Record of Nine Steel Companies," a successful "pilot" study in the area. This study qualifies on the basis of embodying the stated "basic qualifications of an acceptable approach," and the conclusions that Professor Jones had drawn were quite in accord with what has been found to be the predisposition of the Committee. Professor Jones had found the study significant in the following respects:

It is hoped that they (the combined statements for nine steel companies) will help to crystallize opinion by providing a factual basis for discussions which heretofore have had a rather high emotional content. Let us not overlook or underestimate the economic, social, and political implications, for they are far-reaching. Business policies, national economic policies, tax policies, and labor policies since the war have been predicated on large, if not excessive, profits. This analysis, however, shows that real profits were far below reported profits and well below dividend distributions. If similar conditions exist in

other industries, the dissipation of enterprise capital, or at least the brake on capital accumulation, could have serious consequences for the economy.[50]

It would hardly seem that the Committee could have recommended adjusted financial statements with such assurance, leaving details of methodology to be finally spelled out, without satisfying itself that a methodology was available that would give reasonably appropriate results.

The findings of Professor Jones are summarized in capsule form in the study[51] itself:

The company statements show in current dollars:	While the purchasing power statements show in 1935–1939 dollars:
Dividends *earned* by a substantial margin every year.	Dividends *not earned* in any year since 1941.
Income retained to provide additional capital, $543,000,000.	Dividends, interest, and income taxes *paid out of capital*, $409,000,000.
Reported *income* for 1946 before transfers from reserves, $200,000,000.	Real *loss* for 1946 before transfers from reserves, $88,000,000. (Equivalent to $123,000,000 in terms of 1946 dollars).
Net income available to investors in 1947, $356,000,000.	Net income available to investors in 1947, $91,000,000. (Equivalent to $145,000,000 in terms of 1947 dollars).
Working capital increased 51% during seven-year period.	Working capital increased 2% during seven-year period.
Working capital decreased $219,000,000 during 1946 and 1947.	Working capital decreased $394,000,000 during 1946 and 1947.
Fixed assets decreased 6% during seven years.	Fixed assets decreased 19% during seven years.
Preferred stock decreased 12% during seven years.	Preferred stock decreased 48% during seven years.
Excess of depreciation cost over additions to plant, 1940–1947, $46,000,000.	Excess of depreciation cost over additions to plant, 1940–1947, $400,000,000.

These observations place a considerable strain on one's credulity. The steel industry was made to appear in a very sorry plight with fixed assets and working capital depleted (or being depleted), presumably because dividends were being paid which typically were not being earned and because preferred stock had been retired. This impression must be contrasted with the fact that well-nigh production miracles had been achieved over a prolonged period of time and that extensive plans for rehabilitation and expansion were in progress in the immediate postwar period (neither of which are attributes of an industry that is truly decadent). There are also internal inconsistencies within the study. How, for example, can there be disagreement between the company statements and the adjusted statements on whether working capital increased 51% or only 2% during the seven year period; on whether fixed assets decreased 6% or 19% during the period; on whether preferred stock decreased 12% or 48% during the period; on whether depreciation charges exceeded plant additions during the period by only $46,000,000 or $400,000,000? These are all items subject to objective verification and which must have been objectively verified before publication. To adopt a methodology which in effect denies the reality of that which has been objectively verified can but reflect unfavorably upon the methodology.

It may be worth while to digress at this point long enough to show what happens when a methodology produces results which seem to contradict so completely the dictates of common sense. Until recently the finding of a fair present value was an indispensable feature of virtually every public utility proceeding which involved the question of a fair level of rates.

[50] *Journal of Accountancy*, January, 1949, p. 9.

[51] *Ibid.*, p. 13. Professor Jones was Chairman in 1949 of the Committee on Concepts and Standards and was Director of Research for the American Accounting Association, 1950–53.

A methodology had been developed over the years, that had resulted in fair present value being defined as the outlay that would have been required at the time of investigation to acquire the resources then being used by the utility companies. For various reasons, by 1930 the methodology produced a rate base so large that the capital structures of many companies could be handsomely supported by rates which would be "proved" to be confiscatory. A case involving such a condition, which has been in litigation since 1921, reached the Supreme Court of the United States in 1934. Mr. Chief Justice Hughes, who wrote the opinion of the Court, seized upon the inconsistency between the methodological proof of confiscation and the evident lack of confiscation in a common sense use of the term.

> This actual experience of the company is more convincing than tabulations of estimates. In the face of that experience, we are unable to conclude that the company has been operating under confiscatory intrastate rates. . . . Elaborate calculations which are at war with realities are of no avail. The glaring incongruity between the effect of the finding below, as to the amounts of return that must be available in order to avoid confiscation, and the actual results of the company's business, makes it impossible to accept those findings as a basis of decision.[23]
>
> The case has been long pending and should be brought to an end. The company has had abundant opportunity to establish its contentions. In seeking to do so, the company has submitted elaborate estimates and computations, but these have overshot the mark. Proving too much, they fail of their intended effect.[23]

Are not the findings of the Jones study with respect to steel "at war with realities"? There is no way of knowing what the Jones study would show if it were brought up-to-date, but six years and more of hindsight at least indicate that the dark forebodings of Professor Jones have not in any measure come to pass. In fact, quite the opposite is found, for a tremendous increase in productive capacity, as well as other plant improvements, has been acquired along with substantial dividends payments, heavy income tax payments, wage rates edging upward, and minimum resort to the capital markets. And do not the advocates of adjusted financial statements *try* to prove too much with their "elaborate estimates and computations"? Decisions as to what is sound business, economic, tax, or labor policy are not formulated and judged acceptable solely by considering the impact upon business. The impact of any proposed policy upon business is, of course, a proper subject of inquiry, but no evidence has been adduced to show that adjusted financial statements are more useful for this purpose than are the unadjusted statements. Management has some difficult problems to solve which are peculiar to an inflationary period, but adjusted financial statements do not contribute to their solution. Labor and government, too, both have adjustments to make to the conditions prevalent in an inflationary period, but neither for them do adjusted financial statements contribute to the solution. This is simply not the realm of financial statements, adjusted or otherwise.

The lesson to be gleaned from all this is that a basic assumption of the Committee which promulgated Supplementary Statement No. 2 is not well founded. That assumption is that the case for price level adjustments has been proved, that all that remains to be worked out is the methodology. A methodology cannot, however, surmount a difficulty as basic as an improperly formulated principle. It is difficult to see how any reasonably complete methodology (such as is exhibited in the Jones study) will not wind up with conclusions which are equally "at war with realities." The whole case for price level adjustments

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[23] *Lindheimer* v. *Illinois Bell Telephone Co.*, 292 U. S. 151, pp. 163–4, p. 175.

needs to be examined from a fresh viewpoint.

IV

The purpose of this study has been to focus the attention of accountants on the need for a complete reexamination of the problem of "adjusting" to the new frame of financial reference which is implied with any substantial change in the value of money. With no more progress to show after as much time and effort as have been spent on financial statements which have been adjusted in general on the Sweeney model, it should be evident that the problem requires attack from a different angle. One such promising lead is suggested in a quotation from Greer—that the justice of relative distributive shares cannot ever be determined from financial statements much less in a period of inflation. One of the hazards of the wider dissemination of financial information is that the financial information may be improperly used. Proper use of financial information (financial statements) probably imposes an obligation of a closer integration of economics and accounting than has ever been accomplished before. It is in this area that Alexander's "Income Measurement in a Dynamic Economy" represents a laudable and altogether auspicious beginning. The way definitely is not to make price level adjustments to financial statements and then claim that this broadens the area in which financial statements are validly used.

REMARKS BEFORE ANNUAL MEETING OF AMERICAN ACCOUNTING ASSOCIATION*

LLOYD MOREY
President, University of Illinois

IT IS A VERY SPECIAL PRIVILEGE that I am given to say these few words at this annual meeting of the American Accounting Association for a variety of reasons. It is one of the important national organizations of my own profession, in which I have held membership almost from the time it was founded. It is one in which is represented our own fine department of accountancy, in which naturally I take a special pride because it is the department in which I hold my membership in our faculty (and actually render a little service). Finally, it is holding its meeting at our University for the first time in many years.

One experiences a rather special sense of pleasure in being in a profession during the time that it is becoming full grown. That, as you know, has happened to my profession since I entered it about four decades ago. During that time accountancy has emerged from its former vocational status into an activity of high public and economic importance bearing the sure earmarks of a true profession. It has also advanced into a position of high recognition in the educational world, where it has established its right to recognition not only from a *technical* but from a *scholarly* standpoint as well.

A profession achieves its right to be known as such largely by its ability to establish and maintain standards; standards of entrance for those seeking admission into it; standards of practice in its operations; standards of conduct in its relations to the public. On all of these fronts accountancy has moved forward to a meritorious position, mainly in the last half century. For this accomplishment the American Institute of Accountants is entitled to large credit, but the American Accounting Association, which we may speak of as the "academic" area of the profession, also has made a notable contribution.

The term "academic" in the college and university world, as I hardly need tell this assembly, means *teaching and research*. Both are essential in a well-rounded educational program, and the two usually go hand in hand. This Association has taken a leading place in both areas. Its original purpose was the improvement of *instruction* by bringing together those concerned for discussion of topics relating thereto. Its first name—Association of Instructors in Accounting—indicates this as its principal objective. As time went by, a natural expansion into the field of *research* and original study followed, and the name was appropriately changed to its present one. The establishment of a regular periodical of fine quality, the ACCOUNTING REVIEW, has provided the implement for stimulating deepened study and more frequent exchange of ideas and opinions.

We are proud that many members of our University of Illinois Accountancy faculty have joined with those of many other colleges and universities in bringing about this advancement. Some, including our

* This paper was presented at the annual meeting of the American Accounting Association, University of Illinois, on September 1, 1954.

well known former head, Professor H. T. Scovill, were among the founders: others at various stages have made important contributions. (For this convention I understand every member of the faculty, and his family as well, has had to put his shoulder to the wheel, and even the Dean and the President have not been excused.)

Many additional names could be mentioned, but I choose only one—the person we at Illinois have always thought of as the "scholar" of our Accountancy faculty, and one of the outstanding scholars of the accountancy world—*Dr. A. C. Littleton*. I do not need to review before this group the scope, depth, and importance of his work in lifting accountancy to a scholarly plane. To mention only one, the basic work on Corporate Accounting Standards, done jointly with that other fine scholar, Professor W. A. Paton, we all know has done as much as any one thing to bring to the fore the need for refinement and recognition of accounting principles, and to lay the foundation for this important phase of professional development.

Whatever may be the economic success and public recognition of a profession, whatever may be the growth of its membership, however rigid may be its regulations for admission and practice, its true service and its accomplishment will depend on the quality of preparation of its members. This is where our collegiate departments of accountancy and related business subjects must recognize the depth of their responsibility. However well we regard the accomplishments and progresses of the past, there is always more that can be done, better results to be sought, and newer truths and methods to be discovered and developed. So the demands as well as the opportunities for an organization of this kind and its individual members continue without limit.

We should always remember that accountancy is a profession in which only the highest levels of integrity and character are adequate. It is the responsibility of the teacher, therefore, to train the student not only in good technical principles and procedures, but in the fundamentals of attitude and conduct as well. Only if he is so grounded will be he prepared to meet his obligation to the public and his profession not merely as a good *technician*, but even more importantly, as a good *person*.

Again, my congratulations for this fine convention, our thanks to you all for coming here, my appreciation of the opportunity of greeting you and expressing these few thoughts, and my high hopes for continued progress and increased usefulness.

ASSOCIATE MEMBERSHIPS

For the information of teaching members of the American Accounting Association, the number of new Associate Memberships are reported by schools. These include all applications processed by our Secretary's Office during the period of August 15–October 15, 1954. The names of schools are as reported by students.

30–40 members

Alfred University
Canisius College
Ohio State University

20–30 members

University of Colorado
University of Massachusetts
University of Michigan
Wayne University

10–20 members

Howard University
McGill University
University of Florida
University of Los Angeles
University of Texas
Washington University

5–10 members

Catawba College
Iona College
Maryland University
New York University
Northwestern University
San Jose State College
Stetson University
Texas Tech
University of Illinois
University of Miami
University of Missouri
University of Nebraska
University of Rochester
University of Tulsa
University of Utah
University of Wisconsin

less than 5

Akron University
Alabama Polytechnic Inst.
American University
Baltimore College of Commerce
Boston College
Bradley University
B. S. T. C. (Pa.)
City College
College of Steubenville
Columbia University
Carnegie Tech.
De Paul University
Drake University
Duke University
Fairleigh Dickinson
Gannon College
George Washington University
Golden Gate College
Hastings College
Indiana University
Iowa State College
Johns Hopkins
Kent State University
La Salle Extention
Long Island University
Louisiana State University
Louisiana Tech.
Loyola University
Montana State University
North Texas State
Northeastern State College
Oklahoma University
Pace College
Penn State University
Rutgers University
San Diego State College
San Francisco State College
Southeastern University
Southern Illinois University
St. John Fisher
St. Joseph's College
State College Mississippi
State Teachers College Pa.
Syracuse University
University of Alabama
University of Buffalo
University of California
University of Chicago
University of Denver
University of Georgia
University of Iowa
University of Kansas
University of Minnesota
University of Mississippi
University of North Carolina
University of Omaha
University of Oregon
University of Puerto Rico
University of Tennessee
University of Virginia
Virginia Poly. Inst.
Walton School of Commerce
West Texas State
Western Michigan College
Western Reserve
William and Mary

AN EXPERIMENT IN STAFF TRAINING: THE ADVANCED TRAINING CENTER OF THE INTERNAL REVENUE SERVICE

CHARLES J. GAA
Director, Advanced Training Center

ALTHOUGH the idea of an advanced-training center has been considered for the past few years and has been worked on in some detail since early in 1953, the movement did not gain momentum until Congress authorized the use of funds to establish the Advanced Training Center (Public Law 374, 83rd Congress). Statutory authority on a continuing basis will be sought so that a permanent contract for the School may be established.

After the appropriation act was passed, events moved swiftly. The time table was:

May 28, 1954	Passage of Public Law 374
June 28, 1954	Issuance of regulations of the Secretary of the Treasury
June 28, 1954	Invitations to bid sent to ninety-two universities
July 16, 1954	Deadline for submission of bids
Aug. 11, 1954	Contract awarded to the University of Michigan
Sept. 9, 1954	Announcement of names of selectees
Sept. 16, 1954	Selectees reported to the ATC, University of Michigan
Sept. 20, 1954	Classes started

This short time-table proves that Government can act quickly. It also shows plainly the very difficult problem presented to the University of Michigan in planning courses, finding teaching personnel, and in arranging physical facilities for housing, food, classroom space, etc., in a very few weeks. Further, the extremely short period of time between a trainee's selection and his reporting at the Center caused a good deal of personal sacrifice, dislocation, and inconvenience.

Congress authorized the expenditure of not over $400,000 during the fiscal year ending on June 30, 1955, to cover all operating costs of the Advanced Training Center. The Government has the following extra costs, all of which will be accumulated separately in the records and charged to the Advanced Training Center:

(a) Out-of-state tuition fee for each trainee
(b) A very small per diem allowance for each trainee
(c) Travel expenses to and from the Center
(d) Textbooks, but not supplies

Although the trainees are being paid their regular salaries, this is not a "give-away program" for the agents in attendance. The small per diem and the large amount of work required of each man certainly should remove any thought that the trainees are having a "free ride" at Government expense.

AWARD OF THE CONTRACT

Invitations were extended to ninety-two outstanding universities to bid on the operation of an advanced training center for the Internal Revenue Service; twenty-two submitted bids. The University of Michigan was selected by Commissioner of Internal Revenue T. Coleman Andrews, following the advice of his ten-man Special Advisory Committee, which made a detailed analysis and comparison of all proposals submitted. This Special Advisory

Committee is composed of leading members of the American Bar Association, the American Institute of Accountants, and the Tax Executives Institute.

The award of the contract was made on the basis of comparative evaluation of the bids in terms of the following criteria:

a. Size, experience (both academic and practical), and background of faculty available to teach courses in the specified subject areas;
b. Ability to provide courses meeting professionally-recognized graduate school standards;
c. Adequacy of physical facilities available for instruction and housing of Internal Revenue employees;
d. Geographical location;
e. Cost of training;
f. Experience in conducting specialized contract instruction for governmental agencies or for business or professional organizations.

The location of the Center on the campus of an outstanding university and its operation by the university are designed to enhance the prestige of the Center; encourage a high grade of instruction; and have available a fine faculty, excellent library facilities, and a sound curriculum. These tests have been met in excellent fashion by the School of Business Administration of the University of Michigan, and senior staff members have been assigned to handle the ATC classes. A very important consideration in associating the Center with a well-known university was to aid the Internal Revenue Service in its attempt to recruit well-qualified university graduates. The choice of a particular university was influenced in part by its proximity to a large office of the Internal Revenue Service. This consideration has been a wise one, because the Detroit District Office has been of much assistance in performing some administrative services and in furnishing speakers on technical subjects.

PURPOSE

The regulations of the Secretary of the Treasury stated:

> The purpose of this training will be the advancement of the public service by strengthening the tax enforcement system of the Federal Government, and by inculcating the highest professional and ethical standards among Internal Revenue personnel.

Commissioner of Internal Revenue T. Coleman Andrews further explained the goals in this way:

> The purpose of the new center is to broaden the training of Internal Revenue agents by providing them with the knowledge and thinking of leaders of the academic, professional and business worlds. Later on we expect to provide similar training for other professional and semi-professional employees of the Service. Under such arrangements, which will be worked out between our Academic Advisory Committee and University officials, we can look to the future of the Revenue Service with enthusiastic confidence—a confidence which, I am sure, the general public will share. We firmly believe that the added opportunities provided through this higher level training will give us a means of attracting and training the finest young men in the country on a purely professional basis. In turn, this will mean a constant infusion of new blood and leadership and even higher standards of practice and conduct in the Revenue Service in the years ahead. The Service must be dynamic to keep pace with American business, and the training being planned will provide present and future employees with the necessary know-how to meet this need.

ORGANIZATION

The Advanced Training Center organization is a small one, since the instructional work is performed and physical facilities are furnished by the University of Michigan. It consists of a Director of Advanced Training, a secretary, and an Advisory Academic Committee. The Director is a special assistant to and a personal representative of the Commissioner. The Advanced Training Center program is di-

rectly under the general administrative direction of the Commissioner. The Commissioner has delegated administrative direction in Washington to Mr. E. N. Montague, Director of the Personnel and Training Division, National Office, Internal Revenue Service.

The Academic Committee advises on the courses to be offered, the selection of students, and general policies, to insure that the public interest is given adequate consideration. This Committee consists of the following persons:

	Representing
Mr. Ernest Vaughn, Washington, D. C., Chairman	Commissioner of Internal Revenue
Prof. Thomas C. Atkeson, Williamsburg, Va.	Higher Education
Mr. H. T. Chamberlain, Chicago, Illinois	Secretary of the Treasury
Mr. Perry Mason, New York, N.Y.	General Public
Prof. Wm. A. Paton, Ann Arbor, Michigan	University of Michigan
Mr. Joseph S. Platt, Columbus, Ohio	Legal Profession
Mr. J. S. Seidman, New York, N.Y.	Accounting Profession

Within the Internal Revenue Service, planning for the program was carried out by a committee consisting of representatives of the Assistant Commissioners for Technical, Planning, Administration, and Operations.

STATUS AND HOUSING OF TRAINEES

Advanced Training Center students are here in a dual capacity, they are regular employees of the Internal Revenue Service and special graduate students of the School of Business Administration of the University of Michigan. As students, they are subject to the regulations which govern other students and are given the same privileges as other graduate students.

Since the agents in attendance are considered part of the regular student body of the School of Business Administration, they observe regular school holidays. They are not permitted to take annual leave (i.e., vacation leave) while they are at the ATC, except if an important personal emergency arises. Obviously they do not observe the standard Government work week of forty hours but are expected to, and do work evenings, Saturdays, and Sundays as do the regular students at the University. Of course, in this student situation, these long hours are considered part of a normal situation and overtime compensation is not paid and compensatory time off is not given. Their compensation for extra work hours—as for other students—comes in regular school vacation periods at Thanksgiving, Christmas, etc. However, there is some possibility that special work assignments in nearby district offices may be made available during the Christmas vacation period.

Of the hundred agents at the Advanced Training Center, seventy live and eat in University dormitories. The others either live in town in rooming houses or, in the case of some of the married men who have their families with them, in surrounding small towns. At the present time the ATC men are not grouped together in their dormitories. Some thought is being given to requiring all in attendance in the future at the ATC to live in a single group in a dormitory, in the hope that such an arrangement will reduce the personal problems of those not now in dormitories and will facilitate the exchange of ideas and experiences and the presentation of speakers and other ATC activities.

The effect of attendance on the career of the Advanced Training Center student was outlined in IR-Mimeograph No. 54-139, as follows:

> . . . no promise or indication of immediate or future advancement in grade or pay should necessarily be inferred from an assignment to the Center. On the other hand, to the extent that the training enhances an employee's over-all performance and general ability, attendance at the Center can be expected to be a material factor in furthering his IRS career. In regard to promotional vacancies which may occur while an employee is in

attendance at the Center, the employee's opportunities for and rights to promotion will not be adversely affected by his absence. He will receive the same consideration for promotion which would be given him if he were present for duty in his regular assignment and, if selected, the promotion will be effected as of a current, not a deferred, date.

CRITERIA FOR SELECTION OF TRAINEES

Applications were accepted only from Internal Revenue Agents, in grades GS-7 (salary $4205–$5330) and GS-9 (salary $5060–$6185), with at least one year's experience in the Internal Revenue Service, and generally between the ages of 20 and 35 years. The class was limited to 100 persons, although it is probable that later classes will be substantially larger and will be extended to other groups in addition to Revenue Agents.

Each applicant was required to sign an agreement that if he voluntarily resigns from the Service within three full years after completion of the advanced training course, he will repay the IRS for a prorata part of the cost (other than salary) of such training. Also, he may be barred from practice before the Treasury Department for the unserved portion of that three-year period.

The regulations of the Secretary of the Treasury prescribed that selections "shall be made on a merit basis, from employees whose on-the-job experience and previous records attest to their ability to absorb the training to be given, and from whom the Government may expect a high potential of future return in outstanding performance."

MACHINERY FOR SELECTION OF TRAINEES

Approximately 900 applications were received and were sifted down to the 100 which were finally selected. A list of alternates also was prepared to provide replacements for men who could not accept the appointment when it was actually offered to them. Application form (No. 1998) was distributed to all applicants, upon which they stated certain personal facts, their educational background, their special training in accounting or income tax (including Internal Revenue Service courses), and previous work experience.

District Office Evaluation

Applications were screened first in the District Offices, of which there are sixty-four in the entire United States. Evaluation was made on a confidential personnel form (No. 1999) by (1) two of the applicant's immediate supervisors, (2) the Chief of the Audit Division, and (3) the District Director. The two immediate supervisors were required to evaluate the applicant's personal characteristics, work performance, his career plans, and his promotion possibilities and to make a specific recommendation that he be considered for the ATC or not so considered.

Appearance, bearing, manner, ability in oral and written expression, emotional stability, effectiveness with people, mental alertness, capacity for growth, interest, and motivation were the personal characteristics graded. Work performance was judged for quality of work, amount produced, technical ability in interpreting tax laws and regulations, initiative, and resourcefulness.

Regional Office Evaluation

Those applications which survived the screening in each of the District Offices were passed on to the related Regional Offices, of which there are nine. A regional ATC Selection Board considered the applications and made one of the following recommendations to the Regional Commissioner: (1) Selected for next class, (2) alternate for next class (showing rank order among alternates), (3) qualified but

not selected for next class, or (4) not qualified. The Regional Commissioner then made the final selection, ranking each application in one of the four classes just mentioned.

Final Selection

The number of applicants nominated for the first class by each Regional Commissioner was sent to the National Office and a quota was allotted to each Regional Office. Actual selections were then made by each Regional Commissioner by matching his list against his quota.

Selection of Future Classes

Since so many qualified applicants could not be sent to the first class, selection for the second class (February, 1955) will be made from among their number; however, new applications will be accepted for subsequent classes.

There is under consideration a plan to evaluate two or three Civil Service psychological aptitude tests for selection of ATC students by giving them to our present class near the end of the semester. However, some persons prefer to rely on college records when they are obtainable as an indication of aptitude for additional academic training.

ANALYSIS OF ENROLLMENT

We have already discussed the criteria and machinery for selecting agents for the ATC. Here is the result:

By Geographical Location

All but three of the sixty-four District Offices are represented by from one to six persons. One has come from Honolulu. The nine Regional Offices provided the following numbers:

Atlanta	10
Boston	7
Chicago	12
Cincinnati	13
Dallas	7
New York	16
Omaha	11
Philadelphia	14
San Francisco	10
	100

Geographical quotas were used to obtain a representative group of students and to extend the influence of their training widely throughout the Service.

By Personal Characteristics of Selectees

1. *Age*

Early in 1954, an analysis of personnel rolls of Internal Revenue Agents in Grades GS-7 and GS-9 showed that there were 2,356 (out of a total of 5,454) under age thirty-five. Approximately 900 of the 2,356 applied for admission to the ATC. The hundred who were accepted are distributed according to age, as follows:

35	9	29	12
34	8	28	11
33	6	27	9
32	13	26	0
31	19	25	1
30	12		
		Total	100

2. *Grade and Experience*

Most of those chosen are the more experienced and higher-ranking agents; 25 are GS-7 ($4205–$5330), and 75 are GS-9 ($5060–$6185). Their experience with the Internal Revenue Service extended from one to twelve years, in this fashion:

12 years	1	5 years	20
11 years	1	4 years	34
9 years	1	3 years	19
8 years	4	2 years	2
6 years	11	1 year	7
		Total	100

3. *Education*

Their educational background, degrees, and rank in their high school classes are:

Education	
Bachelor's degree	65
Master's degree	6
Work on Master's degree	9
Some Law school	9
Some university work	6
Accounting or business college	5
	100

CPA	
Yes	11
No	89
	100*

Position in High School Class	
Upper one-third	52
Middle one-third	29
Lower one-third	0
Unknown	19
	100

* 2 or 3 are working off a condition on the examination.

4. *Marital Status*

Early in 1954 it was estimated that about 75.5% of GS-7 and GS-9 Internal Revenue Agents under thirty-five years of age were married. Our enrollment actually is 75% married men. Few families accompanied the trainees, in part because ATC announcements discouraged the idea.

IRS TRAINING

All formal training in the Internal Revenue Service, other than that in the Advanced Training Center is directed—in competent fashion—by the Personnel and Training Division in the National Office. It still performs the same functions and has the same responsibilities as before. The Training Division is responsible for recommending training policy, developing program guides, standards and plans, and directing a comprehensive in-service training program to care for the needs of the Internal Revenue Service. In the Regional and District Offices, the Training Branches carry out the training policy and plans, and adapt and develop programs to meet the particular requirements of their offices. The ATC is designed to furnish university academic training at the graduate level, in residence at an outstanding university.

Training Division work is done in these areas:

1. Tax Law, which deals with the subject area covered by most university accounting courses in income tax instruction. These are correspondence courses in Individual Income Tax Law, Corporation Income Tax Law, Excess Profits Tax Law, Estate and Gift Tax Law, Advanced Business and Commercial Law, and Evidence and Procedure.
2. Tax Accounting, which is general accounting instruction, flavored by tax considerations. The following courses are offered in resident classes and by correspondence: Fundamental Accounting, Constructive Accounting, Corporation Accounting, Special Review Accounting, Analytical Accounting, Cost Accounting, and Consolidated Accounting.
3. Executive and Supervisory Development. There is some possibility that the ATC may be called upon to help in this area by presenting advanced executive training programs, along the general lines of those now being presented by universities for executives of industry.
4. Nonsupervisory or Employee Development, which covers clerical and secretarial training, letter and report writing, public relations, and records management.

Training Division work is now being accomplished through: (a) correspondence courses; (b) special schools for selected professional and technical personnel; (c) institutes, conferences, seminars, and resident

classes; (d) instructor-development programs; and (f) staff assistance.

CURRICULUM OF THE ATC

The goal of the training program is to improve the perspective of the trainees, as well as to improve them as technicians. It is not sufficient that the agents be taught techniques and technical procedures in the income tax area. Emphasis has been placed on increasing the agents' knowledge and understanding of business problems and accounting principles and procedures and their responsibilities as representatives of the Government.

Commissioner T. Coleman Andrews's letter to university presidents in which he requested bids for the establishment and operation of the ATC on a university campus, described curriculum requirements in this fashion:

> Initially, a curriculum tailored to the needs of internal revenue agents is desired. Later, courses may be added for the benefit of other technical and administrative specialists.
>
> The curriculum needed for the advancement of revenue agents to higher professional skills of tax administration is a postgraduate course which will be over and above standard accounting and tax law programs. The curriculum should equip and stimulate an agent to evaluate audit problems, techniques, and practices in accordance with the highest professional standards. Those who satisfactorily complete the course should be qualified to progress to more responsible duties—duties encompassing (a) personal performance of audit functions, (b) direction or supervision of audit activities, and (c) executive leadership in broader fields of tax administration.
>
> The audit work incident to the verification of tax returns has expanded to the point where a high premium is being placed on an agent's ability (a) to select for audit only those cases most in need of correction; (b) to exercise a high degree of selectivity in the types of records to be checked; and (c) to avoid detailed checks where the policies, practices, and accounting systems in any given case indicate substantial compliance.
>
> This involves not only improved alertness, imagination and analytical ability on the part of revenue agents, but a basic understanding of the normal and reasonable circumstances surrounding each case. This improved understanding probably must be based on a broad comprehension of the nature of the business in which the taxpayer is engaged.
>
> A broad comprehension of the nature of the business and its related problems can be provided by a thorough grounding in the following fields of study:
>
> 1. Operating characteristics of business or activity, by industry, by size, and by geographical location.
> 2. Corporate organization and finance.
> 3. Types of policy decisions required of business managers and their significance taxwise.
> 4. Management principles, policies, and techniques (including statistical controls).
> 5. Types of accounting systems generally adaptable to various types of business or income—and points of weakness tax-wise when others are used.
> 6. Advanced financial statement analysis and interpretation.
> 7. Case studies of the application of the above materials to the determination of the audit approach to selected situations.
> 8. Interview and other techniques for effective presentation of information and attitudes.
> 9. Special problems of unincorporated business—proprietorships and partnerships.
> 10. Techniques of tax avoidance.
> 11. Audit techniques for individuals.
> 12. Problems relating to estates and trusts.
> 13. Problems of governmental regulation of business, particularly as such controls affect accounting systems (e.g. accounting requirements of Interstate Commerce Commission, Securities and Exchange Commission, Civil Aeronautics Board, etc.).
>
> Intensive training in these fields should help a revenue agent materially to improve his ability to make a number of pre-audit evaluations more effectively—such as,
>
> 1. Types of transactions in the business under study which are likely to result in tax errors.
> 2. Types of management decisions peculiar to the particular business and the nature of their tax effects.
> 3. Accounting systems normally used for each type of business—their strength and weaknesses in correctly determining annual taxable income.
> 4. Attitude of management with respect to strict tax compliance and internal checks adapted to insure implementation of top management attitude.
> 5. Reasonableness of the information included

in tax returns in relation to the normal characteristics of the type and size of business concerned.

6. Pre-audit selection of sensitive accounts to be tested in the event any auditing is deemed necessary.

In order to broaden the outlook of these agents with regard to their immediate work, and to prepare them for possible supervisory or executive assignments, courses should also be provided touching on the fields of executive development, supervisory techniques, and related subjects designed to improve their ability to present written and oral information and to conduct themselves according to the highest standards of public service.

The course of study will, among other things, be designed to clarify and inculcate the principles of business ethics and governmental morality.

Although generally the Internal Revenue employees will have received intensive instruction in tax law subjects prior to assignment to the university, the curriculum should also include some refresher, supplemental, or specialized courses in tax law as may be needed from time to time.

To the extent that may be practicable, courses should be taught by means of seminars, although the size of the student body and other factors may necessitate many lecture classes.

Since the educational and work experience of the students will not be identical, provision will be necessary for optional or selective courses to meet the needs of some of the students.

The details of the curriculum to accomplish the above ends must of necessity be developed in co-operation with the faculty of the university selected to provide the training. Consideration will also be given to the integration of classroom work with laboratory work or field trips.

In addition to the academic instruction to be provided by the university, the Internal Revenue Service will supply appropriate indoctrination or orientation lectures. Such lectures will be given by the Service's liaison representative or other Service personnel.

Required Courses

The following required courses are three-hour courses:

Corporate Accounts and Statements
Financial Policies
Auditing
Income Tax—Accounting
Income Tax—Law

The first two are "perspective" courses and regular catalog offerings but are taught to ATC trainees in special sections apart from other School of Business Administration students. The remaining three required courses have been specially designed for the ATC. Particularly emphasis is placed in the auditing course on weak audit situations in which records are inadequate or nonexistent. The area of income tax has been divided between the two courses by agreement of the instructors. The chief difference between the two courses is in the approach used; one is taught by an accountant, the other, by a lawyer. Apparently the agents have had good IRS training in the past in the accounting approach, but very little in analyzing the law and in doing research on particular cases.

Elective Courses

Each trainee is required to choose (with the advice and consent of the Director) one course out of a list of seven, keeping in mind his previous education and experience and the probable usefulness to him and the IRS of the course in the future. All of these courses are regular catalog courses and the ATC men are mixed in with other students for the purpose of broadening their outlook.

The courses and the number of trainees who elected each one are:

Economics of Enterprise	3
Cost Accounting	6
Internal Accounting and Control	15
Elementary Statistics	0
Principles of Organization	26
Business Statistics	5
Retirement Plans	45
	100

Lectures

There will be fifteen to twenty lectures scheduled at a fixed time of each week during the semester. The lecturers will be drawn from business, the accounting profession, the legal profession, and the Internal Revenue Service. In addition, guest lecturers have been used in particular courses for the presentation of technical subjects.

Work Load

Each of these courses carries three hours of graduate credit. The burden of eighteen hours of course work plus a required-attendance lecture series has proved to be a heavy load, especially when the following factors are taken into consideration:

(a) There are no "soft courses" in the curriculum.
(b) An average graduate student load is fifteen hours.
(c) The ATC trainees have been away from school and study discipline for a substantial number of years.
(d) They have been seriously inconvenienced by the necessarily short notice of their appointment and worried by family problems which have resulted from their attendance.
(e) Competition among themselves has caused many of the agents to perform an undue amount of work on some class assignments.

SUMMARY

The chief difficulties that have been encountered can be traced to the astonishing speed with which the program got under way after Congress appropriated the funds for the ATC. The result was that there was insufficient knowledge of the program and a good deal of personal inconvenience on the part of applicants. More time to permit adequate distribution of information before the men apply and accept appointment should take care of this problem. Since most of the men have been away from school work for a good number of years, they had serious difficulty in adjusting themselves to the discipline of academic life.

The differences between experience backgrounds has raised difficult problems in designing courses in the area of auditing and income tax accounting. To a smaller extent, some differences in educational background have raised problems in the planning of nonaccounting and nontax courses. Probably these difficulties can be reduced by the introduction of more flexibility into the curriculum.

Intensive study is now being given to the curriculum and grading questions on the basis of actual experience, in order to make all advisable changes effective before the second semester training begins.

A good deal of interest in and enthusiasm for the Advanced Training Center has been present in the Internal Revenue Service and at the University of Michigan. The co-operation and assistance from both has been exceptional and very encouraging. Interest also has been demonstrated by requests for admission from persons not employed by the Internal Revenue Service; however, since there is no authorization for extending the training program beyond the Internal Revenue Service, these requests had to be refused.

Under our system of self-assessment of income taxes, co-operation between the taxpayers and the representatives of the Government is essential if we are to avoid the noncompliance difficulties which have been so grave in some other countries. Both the taxpayers and the Government must make an effort to be co-operative and understanding of the problems of the other.

The advanced training program of the Internal Revenue Service is an attempt by the Service to improve its part of taxpayer-Government relationships. It is intended to improve the technical ability and broaden the viewpoint of its agents and to assist in the recruitment of qualified graduates of university schools of business. We hope that a well defined promotion program plus the opportunity to take graduate work at an outstanding university shortly after their entrance upon duty with the Internal Revenue Service will encourage such graduates to choose the Service as a career.

THE PRICE-LEVEL STUDY OF THE AMERICAN ACCOUNTING ASSOCIATION*

PERRY MASON
American Institute of Accountants

FOUR COMPANIES were included in the price-level study of the American Accounting Association. The largest was the New York Telephone Company. The others were manufacturing concerns: Armstrong Cork Company, The Reece Corporation, and Sargent & Company.

The period studied was not identical in each case, but, in general, attention was focused upon the decade 1941 to 1951, during which inflation had been most pronounced. In the case of Sargent & Company, the period 1929 to 1952 was included so as to have an example covering more than one phase of the business cycle. The complete study of the New York Telephone Company was confined to the period 1946–1952, but some data were obtained for the period 1941 to 1946.

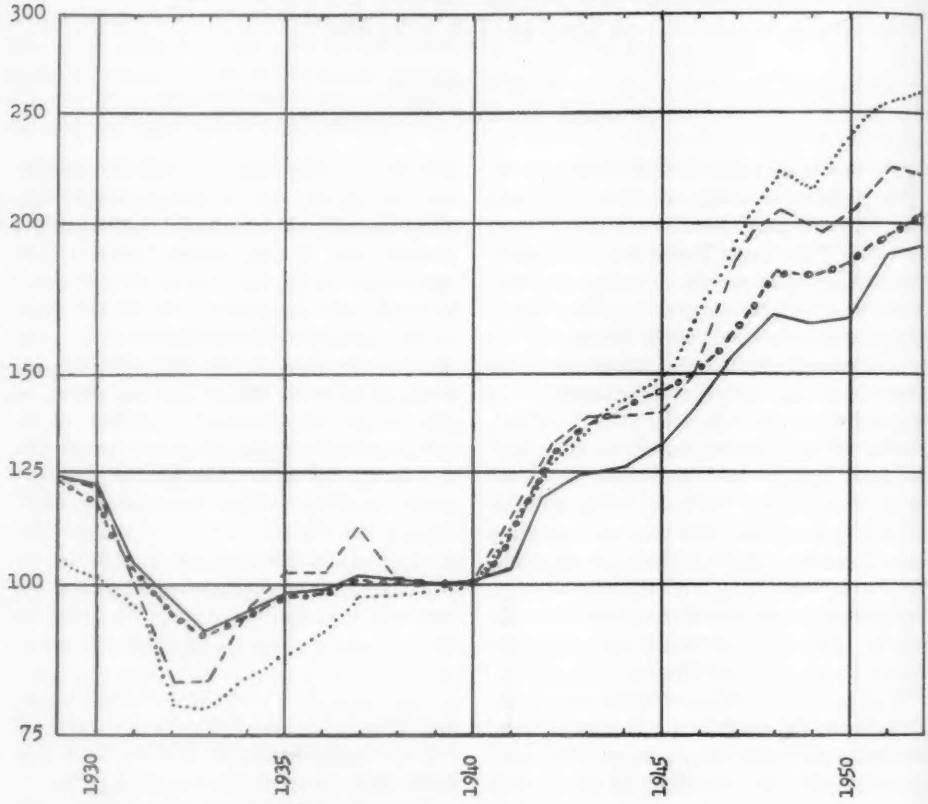
The general procedure followed in the project was to restate the financial statements for each company so as to eliminate, as far as possible, the effect of the change in the price level, or to express each item in terms of the value of the dollar of some one date or period. The average dollar for December 1951 was selected for this purpose. To oversimplify a bit, it could be said that the results show what the financial statements would have looked like if the price level had remained constant at the level of December 1951 during the entire period under study. The dollar of some other date could, of course, have been selected; for instance, the dollar of the base date of the index series would be convenient for regular use because it would simplify the calculations and would make it unnecessary to reconstruct comparative statements each year. The important thing is not the absolute amounts which appear on the adjusted statements, but their relations to one another. We are primarily interested in such things as the trend of sales or the trend of costs, the rate of return, turnover figures, etc. and these will be exactly the same whether the uniform dollar which is used is the December 1951 dollar, the December 1950 dollar, the average dollar for the period 1947–49, or any other that might be selected. It is often assumed that the results will be easier to comprehend if they are expressed in terms of the dollar of the current year, but there is some difference of opinion on this point, and there is the possibility that the results will be misinterpreted if they look too much like the reported current figures.

The adjustments were made with the use of the Consumers' Price Index prepared by the U. S. Bureau of Labor Statistics, not because the cost of living is directly related to the business of a telephone company or a manufacturing company, but because it seems to be generally agreed among those who have investigated the matter that the Consumers' Price Index is the most useful of the available indexes of the general price level. Exhibit No. 1 compares this index with two other general indexes—the index of wholesale commodity prices and the implicit price deflators in the calculation of gross national product. A more specific price index

* This paper was presented at the annual meeting of the American Accounting Association, University of Illinois, on September 1, 1954.

Exhibit No. 1

PRICE INDEXES
1939=100



——— Consumers Price Index, U. S. Bureau of Labor Statistics
– – – – Wholesale Commodity Price Index, U. S. Bureau of Labor Statistics
– o – o Implicit Price Deflators, Gross National Product Prices, U. S. Dept. of Commerce
· · · · Implicit Price Deflators, New Construction Prices, U. S. Dept. of Commerce

—an index of new construction prices—is also included on the chart which, as might be expected, shows a greater amplitude of fluctuation than the more general indexes.

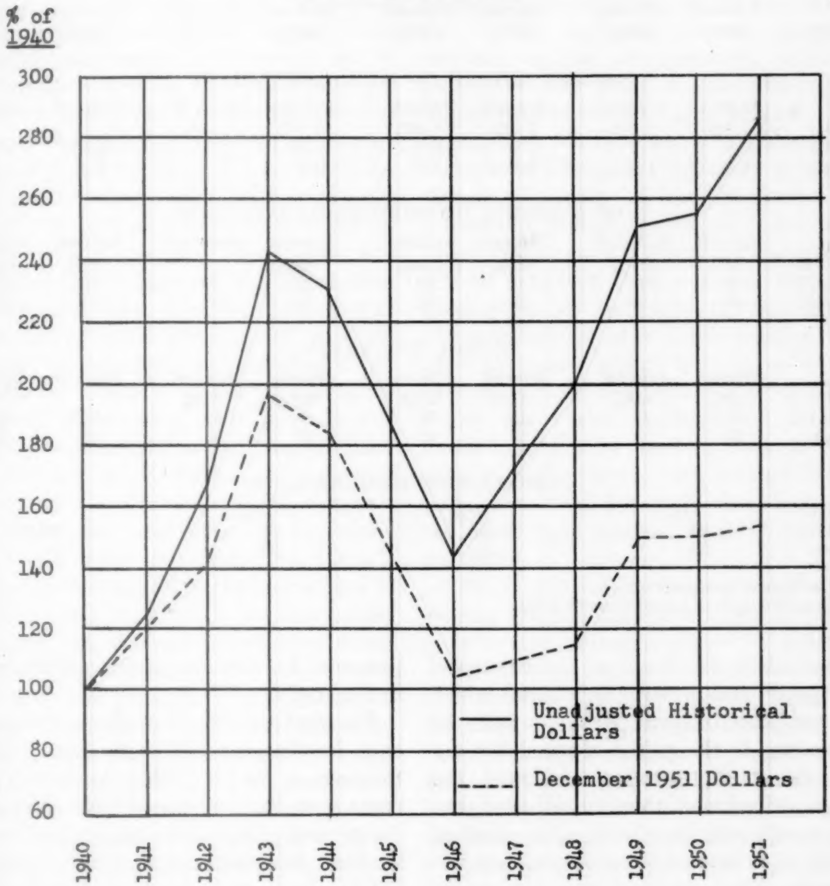
It should be emphasized that no attempt was made to deal with replacement costs. The revised or adjusted statements still reflect the original historical dollar costs, with no change in accounting analysis or methods; the original costs are merely expressed in terms of a uniform monetary unit, the December 1951 dollar.

Exhibit No. 2 is taken from the report which was prepared for The Reece Corporation and illustrates the type of analysis which can be made in a study of this sort. A comparison is made of the reported and the adjusted revenue figures for the period 1940 to 1951, the amounts for each year being shown as a percentage of the year 1940 in order to facilitate the analysis of the results.

In terms of general purchasing power, the revenue for 1951, instead of being al-

Exhibit No. 2

THE REECE CORPORATION
GROSS INCOME
1940-1951
(1940 Gross Income = 100)



most three times that of 1940, is only about one and one-half times as large. In 1943, instead of an increase of about 140% over the sales for 1940, the increase was only about 97%. Although the recorded figures indicate that the war-time peak in 1943 was exceeded in each of the years 1949 to 1951, the adjusted figures show that in terms of comparable dollars the volume of business in these last three years was still substantially below that of 1943 and 1944.

It is important to note that these adjusted amounts do not necessarily represent physical quantities. A specific index of the prices of the products of this company would have to be used in order to arrive at such figures. The adjusted amounts,

Exhibit No. 3

COMPARATIVE STATISTICS

	The Reece Corp.		*Armstrong Cork Co.*		*Sargent & Co.*		*New York Tel. Co.*	
				REVENUE AS % OF 1941				
	Reported	*Adjusted*	*Reported*	*Adjusted*	*Reported*	*Adjusted*	*Reported*	*Adjusted*
1951	226%	128%	256%	145%	204%	116%	242%	137%
				RATE OF RETURN ON TOTAL INVESTMENT				
	Reported	*Adjusted*	*Reported*	*Adjusted*	*Reported*	*Adjusted*	*Reported*	*Adjusted*
1941	7.8%	6.1%	7.4%	4.8%	7.1%	3.6%		
1951	6.9	1.7	7.8	3.1	6.5	1.2	6.2%	3.0%
Avg.	8.0	4.4	8.8	4.5	5.3	1.1	5.8	2.9
				% OF EARNINGS DISTRIBUTED AS DIVIDENDS				
	Reported	*Adjusted*	*Reported*	*Adjusted*	*Reported*	*Adjusted*	*Reported*	*Adjusted*
'41–'45	88%	133%	68%	114%	68%	*	97%	109%
'46–'51	59	107	52	79	29	59	99	159
'41–'51	69	119	56	89	34	135	98	131
				INCOME TAX RATES				
	Reported	*Adjusted*	*Reported*	*Adjusted*	*Reported*	*Adjusted*	*Reported*	*Adjusted*
1941	55%	60%	47%	60%	34%	49%		
1951	59	84	55	74	53	86	48%	61%
Avg.	59	71	46	62	43	75	38	50
				DEPRECIATION DEFICIENCIES†				
1941	5%		7%		7%			
1951	28		30		33		27%	
Avg.	21		25		25		26	

* Too high to be significant.
† As percentages of adjusted depreciation.

instead, show the trend of the command over goods and services in general which the company received from its sales to customers. If the prices charged for the products of the company followed the general price trend, then the adjusted revenue would indicate the trend in physical volume of deliveries to customers, but not otherwise. While physical sales data would be interesting and useful in showing the trend of the physical volume of business, the changes which took place in the buying power of the firm—its command over various goods and services—is really a much more significant matter, since it is closely related to the ultimate outcome, the net income or net loss.

Exhibit No. 3 presents some summary statistics from the four reports which were prepared for the companies participating in the study.

The first set of figures compares the revenue for the year 1951 with that of 1941, the revenue for 1951 being shown as a percentage of the revenue of 1941. Although the general price index went up 76 per cent in that ten-year period (from 62.9 to 111.0), the reported revenue of each of the companies increased over 100 per cent, or more than doubled. This means either that the physical volume went up or that the prices charged went up faster than the general price level, or that both factors were at work. When the figures are put on a constant-dollar basis, the results are much less startling. The revenue of The Reece Corporation increased 28 per cent, that of Armstrong Cork Company, 45 per

cent, that of Sargent & Company, 16 per cent, and that of the New York Telephone Company, 37 per cent.

The rate of return on the total investment is probably the most important single calculation which can be made from financial statements. The second set of percentages shows the rates of return for 1941, for 1951, and the average for the period 1941–1951. (The average percentages for the New York Telephone Company are for the period 1946–1951.) In general, the rate of return on the total investment on a constant-dollar basis was about half of the reported rate. In making these calculations, the net income was taken before deducting interest on long-term debt, and the latter was added to the stockholders' equity to get the "total investment." The net income in these and all other calculations on the exhibit which involve a net income figure was computed without taking into account the purchasing-power gains and losses on monetary assets and liabilities. Except for the adjustment resulting from the conversion of foreign currencies, there is no counterpart of such gains and losses under conventional accounting practices, and, what is more important, the presence of such gains and losses depends upon the plan of financing rather than upon other phases of operations. So it seemed that for the purpose of these statistics, it would be better to omit them in making the calculations.

During the period under study many corporations paid dividends in excess of adjusted earnings, and probably without realizing it. The section of the exhibit showing the percentage of earnings distributed as dividends indicates what happened in the case of these four companies. Over the period as a whole, three of the four declared dividends which were greater than the adjusted earnings—The Reece Corporation, Sargent & Company, and the New York Telephone Company—although the reported amounts indicated that the dividends were well within the earnings. It is noteworthy that three of the companies dropped the proportion of dividends to earnings sharply during the last half of the period, probably due to increased working capital requirements, or to a realization that inflation was reducing the significance of earnings as a guide to dividend policy. In the case of the New York Telephone Company, which is a wholly owned subsidiary of the American Telephone and Telegraph Company, the "dividend" is more of a transfer from a subsidiary to a parent company, but the high proportion of dividends to earnings is characteristic of most public utilities. The amount of net income is only one of the factors which determine the dividend policy, but it seems unlikely that the dividends would have been as large as they were if the adjusted net income figures had been available and had been accepted as more realistic than the reported amounts.

One of the common complaints about income taxes is that they make no allowance for the changing value of the dollar. They tax reported income without taking into account that the amount needed to maintain capital in terms of its purchasing power has substantially increased. Also, firms having a relatively large investment in depreciable assets are discriminated against as compared with other industries whose costs are much closer to current figures. It is interesting to see what happened to the income tax rates of the four companies when they were computed on the adjusted net income. The increase is substantial in every case. One cannot, of course, jump to the conclusion that the total income tax burden on business would be markedly less if taxes were based upon adjusted income since, after all, the government must get its required revenue one way or another, but at least the heavy

industries would not be taxed disproportionately.

The most seriously affected item in companies of the types represented here is depreciation. The next section of the summary shows the relative amount of the depreciation deficiency as percentages of the adjusted amounts. It appears that firms of these types should have provided at least a third more for depreciation than they did from 1941 to 1951 merely to cover original cost measured with a constant yardstick. Notice that this is an original cost concept, not an attempt to cover replacement cost.

As was indicated earlier, the net income figures used in some of the summary statistics in Exhibit No. 3 did not include a deduction or addition for the purchasing-power losses or gains which took place during the period. A summary of these gains and losses is presented in Exhibit 4. They relate to what are called "monetary" assets and liabilities or "fixed dollar" assets and liabilities. The assets are primarily cash and receivables and practically all liabilities and preferred stock are included in this category. The gains and losses are inescapable phenomena of changes in the value of the dollar.

The nature of purchasing-power gains and losses can be illustrated with an incident from one of the cases included in the study. The company issued some preferred stock, the proceeds to be used for expansion of the plant. The money was not spent, however, until a year later and by that time the price level had taken a sizeable jump upward. The result was a substantial loss in purchasing power since the unspent cash bought much less at the end of the year than it would have bought at the beginning. The company was faced with the alternative of finding more capital to carry out its expansion plan or of contracting the scope of its plan. (If prices had fallen, there would instead have been a purchasing-power gain.)

Exhibit No. 4

PURCHASING-POWER GAINS AND LOSSES
1941–1951

The Reece Corporation
Total loss—$900,000
Absorbed by preferred stock—$48,000.
Absorbed by common stock equity—$852,000.
Armstrong Cork Company
Total loss—$9,461,000.
Absorbed by preferred stock—$10,863,000.
Gain to common stock equity—$1,402,000.
Sargent & Company
Total loss—$511,000.
Absorbed by preferred stock—$29,000.
Absorbed by common stock equity—$482,000.
New York Telephone Company
Gain on current monetary position—$12,100,000.
Gain on long-term debt—$135,100,000.
Gain to common stock equity—$147,200,000.

It is important to note, however, that neither the company as a business entity nor the common stock interest was worse off than if the issuance of the preferred stock had been postponed until the very day on which the funds were needed. If there is only one type of stock outstanding, any purchasing-power losses of course fall on the stockholders, but if there is also preferred stock or, for that matter, a bond issue, the loss may be absorbed by the preferred stockholders or bondholders instead of the common stockholders. The point is that ordinary preferred stock and bonds are fixed-dollar claims. As prices rise, the amount of the claim remains fixed in dollars, but declines in terms of purchasing power. So, in this case, since the cash funds were obtained by the issue of preferred stock, it can be said that the preferred stock absorbed the loss in purchasing power resulting from holding the cash unspent for a year.

In general, then, the holding of liquid assets results in purchasing-power losses during periods of rising prices, which may be offset by gains from the maintenance of liability or preferred stock balances. The results of these purchasing-power gains and losses for the eleven-year period for each of the four companies is shown on the exhibit. The losses shown for The Reece Corporation, Armstrong Cork Com-

pany, and Sargent & Company are due to the excess of monetary assets over the liabilities. The New York Telephone Company presents quite a different type of case. As a subsidiary of A. T. & T. it carries relatively small cash balances and normally has an excess of current liabilities over current monetary assets, so it shows a gain on its current monetary position for the period. Then, like most utilities, it has a large proportion of its capital in the form of bonds, resulting in a so-called gain for the period of $135,100,000. The total gain to the common stock equity of $147,200,000 may not actually be available to the common stockholders, but unquestionably their relative position in the capital structure of the company increased. If prices should fall, the shift would, of course, be reversed, and it is important to note that the "gain" will become realized only if the regulatory commission permits the utility to earn its rate of return on the adjusted investment.

So much for some of the results of this experimental study; now some conclusions.

It seems clear that there *is* a serious problem. If inflation makes the rate of return look twice as high as it is when measured in constant-value dollars, if dividends turn out to be in excess of adjusted earnings, and if sizeable losses occur merely from the holding of liquid assets, the effects are not to be taken lightly.

The experiment has shown that it is feasible to recompute the financial statements so as to eliminate the effects of inflation. The men used on the project were typical practicing accountants of about the senior level. No special training in economics or statistics is required. The most time-consuming part of the work is the analysis of the plant and equipment accounts and the corresponding accumulated depreciation. They must be analyzed by date of acquisition, and the retirement of fixed assets from service must be analyzed in the same way. It is this step which will account for the large disparity which may be found in making the adjustments between the costs of one company and those of another. If good plant records are kept on punched cards, the analysis can be made quickly and cheaply. If the plant records are inadequate and the acquisitions and retirements must be traced back through the records, the process can be time-consuming and expensive. In some cases simplifying assumptions can be made such as the first-in, first-out assumption that the oldest item of equipment is retired first, but such an assumption has limited applicability. The greatest part of the cost must be incurred the first time that a conversion of the financial statements is made. The extension to future years is a relatively simple matter which should take no more time than the preparation of any ordinary set of statements.

The adjusted statements should be useful to management. Attempts were made through consultations with officials of the companies studied and by correspondence with members of various consulting groups to get reactions on this point. It is, however, asking the impossible to expect an official of a company to indicate whether or not his decisions and policies would have been the same or different if he had had adjusted statements available during the past decade. The typical reaction was that the results were very interesting and that they confirmed with greater precision the general impressions which the official had had as to what was going on and which he tried to take into account in making decisions. One firm indicated that its price policy certainly would have been modified if the information had been available. The board of directors of another company reduced the dividend upon reading its report. Dividends are determined

by a number of factors, but at least adjusted earnings provide the directors with ammunition to fight off unreasonable demands for dividends by stockholders.

Another difficulty relating to the usefulness of adjusted figures to management is that these adjusted amounts are still just original cost figures expressed in terms of a uniform dollar. For many of its decisions management needs current or replacement costs, not original costs, and this is true whether or not the price level has changed. (When we say that the price level remains constant, we do not mean, of course, that all prices remain constant; some go up and some go down, even though on the average they remain at the same level.) If, for example, the management is considering the replacement of a high-priced machine tool, it is what that particular machine will cost, not what the old one cost either in terms of original or adjusted dollars, which must determine the action which is taken.

Perhaps the greatest interest of management in adjusted figures is based upon the hope that they can be used for income tax purposes, at least during periods of inflation. This enthusiasm will probably diminish in a period of falling prices. A good case can be made for income tax relief and the elimination of the discrimination which results from varying degrees of depreciable assets. While complete equity on tax matters cannot be achieved, it is hard to see why the heavy industries should be penalized as they are.

The investor is probably the one who would benefit most from the publication of adjusted financial statements. As it is, neither he nor his analyst has an effective way of interpreting the figures which are given to him. The sales figures may look as though the volume of business is expanding, while just the reverse may be true. He has no way of comparing one company with another as to its vulnerability to the effects of inflation or deflation. He can not tell whether the dividend policy of the company is reasonable or not. Adjusted figures should help him a great deal.

Anyone who is interested in promoting the development and use of adjusted statements has to face the fact that interest in the problem diminishes when prices seem to be leveling off, as they have been recently. If prices remain on an even keel for several years, one would have to predict that the problem would continue only as a matter of academic interest. The fact that prices have leveled off, however, does not mean that the inadequacies of conventional statements have disappeared. For at least a decade, in most cases, the accounts will reflect depreciation at the old obsolete historical dollar costs and the need for adjusted figures will still continue. There is still need for further experiments and further study so that some day everyone concerned will be convinced that price-level adjustments of financial statements are feasible and useful.

THE LOGIC OF ACCOUNTS

A. C. Littleton
Professor Emeritus, University of Illinois

This was the appropriate title for the text in which an American, E. G. Folsom, made a praiseworthy attempt two generations ago to show the student that bookkeeping procedures reflect rational purposes and implement reasonable and understandable objectives. His pedagogical intention clearly was one of easing the learner's task by teaching him the thought processes behind the technical features of double entry. In this approach he displays a penetrating insight into the weakness of learning a technology by memorizing rules for dealing with typical situations.

Recognition of this same distinction between pedagogical methods was, a generation later, an important factor in gaining the acceptance of accounting as subject matter appropriate for college level classes. College courses which make no more contribution to the student's mental development than that involved in learning rules by heart and applying them clerically to routine situations do not deserve a place in college catalogues. The reason is not found in the subject matter but in the method by which the teaching materials are used. Since higher education exists to foster higher mental development, every subject plus its teaching method should contribute to that goal. A review of the changes taking place over a half century will show that this conception has been steadily at work in accounting instruction and that the usefulness of the subject for stimulating mental development has been steadily improved at the same time that instruction in its technical aspects has kept pace with growing need in business for increased accounting technology.

Perhaps Folsom was conditioned by his education to attempt the broadening of instruction in bookkeeping. He signed his book as a master of arts and displays an acquaintance with the economics of his day far beyond that reflected in most contemporary text books on bookkeeping. He was not the first to try to break away from the time-favored descriptive approach, but he seems to have succeeded better than others. For example, he utilized economic theory—he mentions Mill and Carey specifically—to undertake to wrest the student's grasp of accounting upon some certain concepts from economics. In doing this he put more discussion (theory?) into his text than others had done. About one-fifth of the total pages were used in this way.

In both editions (New York, 1873, 1881) he lays stress throughout upon the concepts of capital, of value, of service. Not all property, he points out, is capital. To be capital, property must be devoted exclusively to some business enterprise with a view of realizing profit. Capital thus set apart constitutes a business which from its beginning establishes relations between itself and all parties dealing with it.

Here Folsom plainly indicated the separateness of the enterprise and the sources of enterprise capital. Elsewhere he strongly stresses service as the principal factor responsible for increases and decreases of enterprise capital. Thus he associates the concept of profit with reward for services rendered. His nominal accounts are labeled "received service" on the debit (expense) side and "gave service" on the credit (revenue) side. Since the proprietor can only serve and be served, as the author writes, we may now add the thought that the proprietor looks to his expense and

goods accounts to learn the extent to which he is being served by possessing the means of serving others, and to his sales revenue and other earning accounts to learn the extent to which he has served others.

While Folsom did not develop his ideas this far, his mind nevertheless convincingly reached into the entity concept of capital and profit: the enterprise is a separate entity; holds all assets (capital) for enterprise purpose regardless of the source of assets; net profit comes to the enterprise before it reaches those who supplied assets; enterprise profit comes, not from holding assets and revaluing them as prices rise, but from the service rendered to customers that is made possible by the possession and exchange of enterprise property (capital).

It seems very unlikely that Folsom would have been receptive to ideas about replacement costs being reported in the financial statements, or to the use of appraisal surplus as a basis for cash dividends. The conditions which long after his time generated such ideas were not present early enough to disturb this author's logic. But because this thoughtful writer presented the essence of double entry theory with so much logical insight and because the logic inherent in double entry objectives and methods has gradually become better understood, we need not in 1954 be so easily persuaded towards an expedient concept of enterprise net income, and toward viewing the financial statements resulting from double entry technology as so loosely integrated that, as has sometimes in recent years been intimated, they need not be interlocked at all.

One of Folsom's aims in writing his text, like that of many other authors, was to teach the student how to analyze transactions into debits and credits for entry into double entry ledger accounts. Although he logically rests his explanations upon useful concepts from economics, he gets tangled up (in the 1873 edition), as others had been, by an inherited terminology wherein debit meant "owes" and credit meant "is owed." Thomas Jones before him and Charles Sprague after him escaped this trap and taught that the terms of Latin derivation no longer meant what they did originally. Folsom gave examples of transactions reduced to equations; but he did not teach students to think of entries in accounts merely as arithmetical increases and decreases in carefully defined categories.

His equations are based on his principle that "all transactions have their origin in an exchange of values" and "in all transactions there is a co-equal receiving and giving of values." These ideas he develops (in the 1881 edition) into six equations of values exchanged, using three basic terms as the equation members. These terms are tied to the concept of service. "Commodity" is stored service of the past; "claim" is service promised for the future; "service" which is "incorporeal and unembodied." This last phrase, perhaps unconsciously but nonetheless clearly, reflects the sense of the word "nominal" as now applied to one group of ledger accounts, although we can now see that the information in these accounts, method of being insubstantial (nominal), is very real and useful to management.

His equations are these:

Service = Service	Service = Commodity
Service = Claim	Commodity = Commodity
Commodity = Claim	Claim = Claim

Every transaction can be expressed in one of these forms.

Like other authors he stumbles over the problem of distinguishing between expense and loss. This is another instance of the difficulty of shaking off the influence of earlier modes of thought. The importance of "proprietor" in proprietory bookkeeping was so great (in comparison to

agency records without ownership) that expense and income were traditionally explained as loss and gain to proprietor. As such, they could be fitted into journal entry equations and students finally learned thereby to translate familiar transaction data into ledger account data. Now we see that nominal account debits do not speak of proprietorship loss, and nominal account credits do not speak of proprietorship gain. Instead, nominal accounts tell of certain active types of increase or decrease in enterprise net wealth, sharply different from those changes in net wealth which come from loans or investments. Such explanation helps us today to face the pedagogical problem of preparing students in their first course to understand cost accounting entries when later they meet them.

Here is a spot where Folsom has something for us even though he misses the concept of expense by calling it loss—that is, paying for a service which is not exchangeable. Here he mentions interest, rent, commissions. Along with rent, etc., he includes the consumptive use of materials, fixtures and other incidentals. He therefore does realize that costs can attach to product. In connection with the above phrase "consumptive use of materials etc.," he adds, "These are in the nature of losses unless services of these kinds are treated as embodied in the merchandise and are charged in with it as enhancing its value." Cost accounting in Folsom's day was not well developed, but here he expressed the conception that costs and appropriate expenses attach to the merchandise purchased. That is part of his "accounting logic." It was likewise logical—when the time came—for relevant manufacturing costs and expenses to attach to the product manufactured.

Folsom, without developing the matter, seems almost on the point of drawing the very modern distinction between cost, expense, loss. When and if an author succeeds in making these distinctions for his reader, it may be taken as an indication that he has pushed his mind behind the clerical procedures of bookkeeping and into an appreciation of the real essence of double entry, namely, the meaning and usefulness of impersonal accounts, especially those for cost, expense and loss which we now call nominal accounts.

Like some other text writers of the nineteenth century, Folsom is carrying on a part of the step-by-step evolution of bookkeeping (and accounting) theory. He therefore has contributed to a gradual broadening and deepening of our ability to understand what accounting really is and how it could possess great usefulness over several centuries, and more and more usefulness as its evolution continues. Although this author, like his contemporaries, misses many opportunities to speed up accounting theory, this in no wise detracts from the valuable insight he was able to pass on to his students. It must have often lodged in fertile soil, this striving to tie accounting into economics. To those of his students who wished to understand more than the formation of journal entries, it must have been helpful to read in an early page that we gain in business because we bring new-born value into the sphere of exchange. With that idea as a basis, students have an exceptional basis for developing an interest in and understanding of the nature and usefulness of nominal accounts. With such a start the small technical aspects of double entry can readily be made understandable. We are still learning how to use this logical approach to understanding double entry.

RESPONSIBILITIES OF THE PROFESSIONAL ACCOUNTING FIRMS IN CONTINUING THE TRAINING OF COLLEGE GRADUATES*

HUGH MACAULAY
Arthur Young & Company

WHILE THIS PAPER is entitled "Responsibilities of the Professional Accounting Firms in Continuing the Training of College Graduates," it will actually cover some of the means used by the professional firms in training young staff members, with some thoughts as to how these can be further improved.

Aside from our responsibilities to help provide for the further growth of the profession, it may also be said that it is to our own self-interests to develop fully our staff members as quickly as possible. For many years now there has been a somewhat severe shortage of top senior accountants in this country. While this has been due in part to the disruption caused by wars and near-wars and in part to the unusual opportunities in private industry for accountants, it also probably has been due to the failure of the profession to appreciate fully that the situation will be a continuing one unless it is vigorously attacked. Whatever the causes, however, the result has been that there has fallen on the partners and principals of the professional firms a burden which could have been shared by additional top senior accountants had they been available. The profession would probably have advanced even farther than it has had the persons at the supervisory level been able to devote more time to the problems confronting the profession and to the expansion of the services the profession can render to the public.

Turning now to the matter of training staff members, I find a great deal of interest in training programs among the students I interview at the various universities I visit in search of prospective employees for our firm. To the teaching profession is due the credit for instilling this interest in the students.

Since I know the training program of our firm much better than those of other firms, I will base most of my remarks on it.

To begin with, we are keenly interested in the internship programs which many of the universities conduct, and we have had that interest since the 1930's to my own knowledge. As a matter of fact, several of our present partners originally came with the firm as interns. The greatest advantage to the participants in the internship program is the fact that an individual has an opportunity to learn something about the practical side of public accounting before his graduation. He has a chance to find out whether public accounting is really as he imagined it and whether he will probably be happy in his work. Further, he usually receives greater benefits from his remaining courses in college than he would otherwise because of the practical experience.

Of course, most interns go into the profession upon graduation, many of them with the firms with whom they interned, but there are a few who find out that public accounting is not for them. I wonder how many of the latter make such a decision because of unfortunate experiences during

* Presented at the Sixth Annual Meeting of the Southeastern Group, American Accounting Association, University of Florida, on May 7, 1954.

their internship. Were some of them put on a single large engagement and assigned only mechanical work such as checking footings and extensions of the inventories? Here is where the firms have a real responsibility, and I believe most of us fully realize it. The intern should be given as great a variety of assignments as possible. Most of the work must be somewhat routine, but, if it is on different engagements or on different parts of an engagement, it should be interesting to the individuals who are destined for success in the profession. The firms have a problem in making this variety of work available to interns, as someone has to do the routine work, and, if the interns don't do it, who will—last year's interns, who are expecting more advanced work? Nevertheless, I believe the firms can use greater judgment than they have in the past in the interns' assignments.

When the college graduates begin their employement, more formal training is given them than is possible during their internship. Training programs vary by firms and even by offices within a single firm. Obviously, large offices are able to conduct much more intensive programs than can small ones.

I will begin by outlining the program followed in the larger offices of our firm. The sequence in which the various phases of the program are discussed is based on June graduation, as that is when most college graduates come with us. Those who graduate at other times of the year are fitted into the program in the best manner possible.

First, the new staff members attend a short indoctrination school, which assists them in becoming familiar with our audit procedures, forms, and working paper requirements. At this time they are given a copy of our audit manual, which is not intended to be a repetition of auditing texts, but rather a practical guide to auditing problems and procedures. Another helpful aid given them is an internal control questionnaire, which is used in making a comprehensive survey of a company's internal control during the course of our audits. They are also supplied a model report on examination.

This indoctrination school lasts for only a few days. We do not attempt to put the new staff members through a school of several weeks' duration at this time, as we feel it is of more benefit after a year's practical experience. We also find most individuals are tired of school at this time and do not devote their full energies to additional schooling.

The new employees are next given a few weeks' experience in our report department. While a portion of their time is spent in proof-reading and checking footings and extensions in typed reports, we emphasize the importance of having them make an independent review of the reports. Many times we find that they have valuable suggestions as to the content of the reports. Some things which make sense to the person who wrote the report are not understandable by others unfamiliar with the details of the client's business, and require clarification. The report department experience helps the staff members to write better reports when it becomes time for them to do so.

Next, the new employees are sent out on various engagements for several months. Here it is just as important to give them varied experience as it is for the interns. They receive very close supervision, of course, and are encouraged to ask questions concerning procedures or problems they do not understand. They are also encouraged to study the literature given them as a means of continuing their education.

During the spring months a few more weeks are spent in the report department, after which staff schools of three or four weeks are held. Normally, no more than fifteen or twenty individuals are in a single

class. The classes are held during regular working hours. One individual generally conducts the school, but specialists in SEC work, taxes, methods, etc. give special talks before the class. Besides reviewing our own literature in these schools, publications of the American Institute of Accountants, such as the auditing and accounting research bulletins and the case studies of audits and internal control, are dealt with at some length, as is also SEC material. The schools are conducted on a seminar basis so that there may be adequate discussion and active participation.

After an individual finishes the staff school, he goes back on audit assignments, but his training, of course, is still not complete. As time goes on he should require less and less supervision and should advance in standing on the staff, if he is to be successful. As an aid to this advancement, he attends staff meetings held at frequent intervals throughout the year. The purpose of these meetings is to provide a forum for the discussion of current accounting problems. Again, the staff is encouraged to participate actively in the discussions. Only a few supervisory personnel are present at these meetings to help guide the discussions.

One might say at this point that the foregoing is fine for the large offices of the large firms, but what about the college graduates who start in smaller offices? How are they to receive proper training? A small office of a large firm has the opportunity of sending their juniors to the staff schools in the larger offices, but most of the training has to be on a much more individual basis. This is true also of the smaller firms and individual practitioners. The supervisory personnel must give the newer staff members on-the-job training and assist them in continuing their education in whatever spare time is available.

Here is an area where I believe the profession can do a great deal of good on a cooperative basis. It is my understanding that the C.P.A. societies in California and New Jersey have organized courses especially designed for junior accountants. The New York society is considering a similar course. These courses are conducted by universities under the auspices of the societies and cover subjects similar to those discussed at our staff schools. These seem to be very worthwhile efforts, and it is to be hoped that other state societies will undertake similar programs. Even though it is not practical to undertake such formal programs in some areas, it is still possible for the local chapters of the state societies to organize forum meetings aimed at the level of the junior accountants.

In some areas non-certified staff members of the firms are permitted to become associate members of the state societies. Where this is possible, these individuals can be made to feel more a part of the profession if they are encouraged to attend chapter meetings and take part in other society activities.

The foregoing are just a few thoughts concerning training programs, but, in closing, I wish to mention something which has a bearing on training. This has to do with maintaining staff morale at a high level. The best training program is of little value if each staff member is not made to feel that the firm is interested in him as an individual. One of the best ways of accomplishing this is for a responsible person in the firm—not necessarily the personnel manager—to spend a few hours from time to time discussing with an individual his progress, pointing out his weaknesses, along with suggestions as to how they may be overcome, and encouraging him to discuss any complaints he has concerning his activities in the firm. The latter is most important as an individual is of little use to himself or to his firm if he bears any sort of a grudge against the firm because of real or fancied unfair treatment.

THE NEED FOR COLLEGE COURSES IN INTERNAL AUDITING

EARLE H. CUNNINGHAM*

THE NEED for college courses in internal auditing is a much debated subject. While college educators hesitate to add special courses to an already crowded curriculum, those interested in the field of internal auditing see the need for a higher grade of training for the internal auditor than is currently available. This need stems, primarily, from the broader responsibilities assigned to the internal auditor, and the increasing range of services he is required to render.

The early type of internal auditing was largely a clerical activity maintained for the purpose of detecting and preventing clerical errors and fraud; and the internal auditor rarely operated outside of the field of general accounting. While some of the larger companies developed their internal auditing to a fairly high standard during this early era, there was little uniformity in the requirements of the internal auditor. This condition can be appreciated when it is realized that prior to 1940 there were no text or reference books on this particular business function, and no authoritative definition of internal auditing.

Each company making use of internal auditing created this function in accordance with its own concepts and particular needs. In those cases where all operations were established at one location, were controlled by one accounting system, and were subject to close management supervision, the clerical type of internal auditing generally prevailed. The internal auditor's duties consisted of such routines as checking mathematical computations, testing distributions, determining sufficiency of approvals, effecting reconciliations of accounts, substantiating balances, ascertaining the adherence to policies and procedures, and similar matters. Under present concepts the employe performing such services would be termed an "audit clerk."

In contrast to the foregoing there were some companies such as railroads, packing companies, farm implement companies, and automobile companies, which had scattered operations. Factories, warehouses, or branch stores were established at points of economic value to the company and its customers. The remoteness of these operations presented many management problems. Daily observations and supervision by top management were not possible, and the performance of branch management had to be evaluated largely through the medium of reports. To assure that directives and procedures were being observed, that cash and property values were being conserved and properly accounted for, that company policies were being carried out, and that operating and other reports were factual and properly prepared, management found it necessary to create an impartial inspections agency for the purpose of making periodic examinations of branch operations: a staff of traveling auditors.

The traveling auditor provided management with a practical and effective means of contact with field operations. The character of services rendered was largely responsible for elevating the "traveling auditor" to a much higher status than was enjoyed by the "audit clerk." Management had to depend upon the traveling auditor for much of the unbiased and in-

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dependent reporting of branch operations. Contrary to current practice, some companies in this early era conferred upon their traveling auditor considerable management authority. In some cases he was authorized to hire and release personnel, change or modify routine procedures, and perform various other specific acts. Surveys and investigations were frequent assignments, and valuable information was passed to top management through the medium of the traveling auditor. Undoubtedly, it was management's experience with this type of internal auditing that contributed largely to its development. However, the development was on an individual company basis, since there was little exchange of business information among companies in these early days; and there was no available material defining the duties and responsibilities of the internal auditor.

With the publication of Brink's[1] book on internal auditing, and the organization of the Institute of Internal Auditors in 1941, concepts began to crystallize and basic standards of practice were developed. These factors, along with the management problems which developed as a result of World War II, caused internal auditing practice to spiral to new heights, both in quality and quantity of practice.

While normal management problems have been constantly increasing over the years, World War II brought a pyramid of new problems. The social and economic problems that have developed in the past ten or fifteen years have been so vital to business that management has been forced to devote a large part of its time to their solution and administration. This condition has forced top executives to delegate many of the normal duties that they formerly performed. Today, the administrative problems of our larger companies are so numerous and complex that top management can do little more than to formulate policies and procedures, and review and interpret reports on operations. Even in our smaller companies, management is finding it necessary to delegate more and more of its responsibilities to subordinates for execution. The increase in management problems over the years has forced management executives farther and farther away from line operations and has curtailed the opportunity for personal observations and evaluation of operating activities. As a result, management has been forced to rely more and more upon its system of internal control to provide operating data and the assurance that its directives were being faithfully executed. The type and number of individual controls making up the over-all system of internal control will vary with the size and nature of the business and the requirements of management. Some of the more common controls are:

1. Supervision
2. General Accounting
3. Internal Check
4. Internal Auditing
5. Cost Accounting
6. Budgetary Control
7. Procedure Manuals
8. Statistical Reports

Each type of control has its own important part to play in the general scheme of management; and most of them interlock with the general pattern of operations to such an extent that they become an integral part thereof.

While "internal auditing" is one of the several controls maintained to serve management, it differs from most of the other types of control in that it acts as an independent agency, and is charged with the responsibility for measuring and evaluating the adequacy and effectiveness of other controls.

The best system of internal control ever devised will not sustain its par of performance and effectiveness without

[1] *Internal Auditing*, Victor Z. Brink, Ronald Press, New York, 1941.

proper maintenance. Policies, procedures, internal check, and other routines are subject to deterioration and obsolescence as much as physical properties. Though they may be entirely adequate at the time formulated, changing conditions are bound to have an obsoleting effect. It is the responsibility of internal auditing to keep other forms of control under close observation, and to make frequent tests of their adequacy and effectiveness.

Because of the internal auditor's responsibility in respect to the system of internal control, it is important that this subject be given considerable emphasis in any contemplated training program. The student should be well informed on the nature, objective and relationship of the various individual controls, and the internal auditor's responsibility in connection with each.

Much of the inspection work and checking performed by the early type of internal auditor was against established standards or predetermined objectives, and did not require the exercise of management judgment. The internal auditor was frequently referred to as a "checker." But today, the internal auditor is viewed as an appraiser. It is his duty to observe, review, inspect, appraise, and report his conclusions to management. His broad responsibility in this respect will cause him to deal with many problems, some of which may involve expensive and radical changes. His appraisals must be sound and amply supported by adequate working papers and supplementary data. In many cases there will be no established standards or predetermined objectives for him to use in formulating his conclusions. Such instances call for the exercise of judgment based on a thorough knowledge of the business. To be able to measure up to such issues, the internal auditor must be a constant student of his company's affairs. No other employe of the company has such an excellent opportunity to gain a comprehensive knowledge of the business, as does the internal auditor. His unlimited right of inspection provides him access to every phase of the company's operations. The degree of business knowledge that he acquires through this opportunity will be reflected in the quality of the appraisals that he will have to make.

While checking and verifications are still a part of the contemporary internal auditor's routine, training programs should point out that the emphasis is more on appraisals. The successful internal auditor must be constantly alert for matters that may need inspection and appraisal. As he travels about the company he must critically view all matters coming within the range of his responsibility to determine their need for close inspection and appraisal. Some of his inspections and appraisal responsibilities relate to specific matters that have been assigned to him by management. Others relate to matters that are an inherent responsibility of the internal auditing function, and do not require specific assignment to the internal auditor; they become his responsibility by virtue of his position. The following are mentioned as examples:

1. System of internal check
2. Company, staff and department policies
3. Company, staff and department procedures
4. Care and storage of company records
5. Care and storage of company property
6. Compliance with external regulations
7. Reliability of accounting and statistical data

In addition, the internal auditor has the inherent responsibility for keeping management informed on all matters coming under his observation which he feels it should consider. However, he should not undertake to duplicate or usurp the duties of other special controls, if they are adequately reporting. For example, he should not concern himself with the development of statistical information or cost analyses, if the departments responsible for furnish-

ing these data are adequately discharging their duties. However, he does have the inherent right to inspect their activities for the purpose of determining the degree of their effectiveness and their compliance with established procedures.

The internal auditor has the inherent responsibility for being alert to the possibility of waste, hazards, and other exposures; and also, for pointing out existing deficiencies, that management may take appropriate corrective action.

While much of the internal auditor's inspection duties relate to accounting and financial activities, current concepts have broadened his inspection responsibility to include many operating functions and other non-financial and non-accounting activities. The extent to which the internal auditor may operate in this direction depends upon his management's understanding of the utility of modern internal auditing practice.

The development of internal auditing to its present high standard, has provided management with a personal and effective means for maintaining contact with field and line operations. It frequently takes a long time to get policies formulated by top management, properly interpreted and working smoothly at the lower operating levels. This is a weakness that exists in many of our larger companies. Likewise, it takes a long time for the thinking and reactions of line employes and lower levels of supervision to filter through the various barriers to top management. The internal auditor, because of his close association with all levels of management and line employes, becomes a valuable liaison for interpreting policies, smoothing out misunderstandings, and promoting organizational good will. It is activities of this nature that emphasize the internal auditor's need for special training in human relations and communications.

Most of the normal and regularly recurring needs of management are satisfied through special staffs or departments. However, many problems develop which are of such a nature that they do not normally fall within the area of any established department, or are of such a character that their solution would be better handled by an independent agency. Most problems of this nature involve surveys, investigations, or special audits. For example:

1. Request from a supplier for a cash loan
2. Request from a customer for an extension of credit
3. Charges by a supplier for the cancellation of a contract by the company
4. Special audit re contemplated purchase of related company
5. Propriety of charges made by a sub-contractor
6. Verification of charges made under a cost-plus contract
7. Investigation of inventory losses
8. Survey of shipping and receiving procedures
9. Gathering specific information on internal operations as may be requested by management

Internal auditing, generally, does not have a "dead-line" for the completion of its various duties, which makes it immediately available to management for such services as may be required. This fact has contributed to its use as a "tool of management."

The utility of internal auditing and the degree to which it may effectively serve management is only limited by the ability of the internal auditor.

The rapid expansion of auditing requirements during recent years, and the general acceptance of contemporary concepts of internal auditing, have found many auditing departments unprepared to render fully the character of service that management needs.

To develop existing audit staffs to the required level of ability, some companies provided staff training programs for their employees. Others prepared suitable material and made arrangements with a local school for its presentation as a special

course. To supplement this activity, several chapters of the Institute of Internal Auditors conducted study groups for the benefit of its members. Later the Institute prepared a course outline for the benefit of those schools and colleges desiring to introduce an internal auditing course. Most of these special courses were developed to satisfy immediate and pressing needs, consequently they dealt almost exclusively with internal auditing techniques, basic principles, and philosophy. They were developed during the period when concepts were being crystallized and basic standards were being established. Naturally, they did not comprehend the full range of needs as currently viewed. These initial courses served a very important objective, but they did not provide the breadth of training that is now considered necessary to qualify a student for the field of contemporary practice.

Since the contemporary practitioner is required to assume much broader responsibilities than formerly, and is expected to render a far greater range of services, he must be well informed on all business functions and be familiar with their basic principles and objectives. Otherwise, how can he inspect and evaluate their performance? The internal auditor who serves management to the fullest extent, must be qualified to make inspections, reviews, and evaluations at the management level. He must be able to weigh situations in the light of management interests, and arrive at sound practical conclusions. While much of the ability to carry out this broad responsibility must be acquired through actual experiences, college courses can aid materially in preparing the student for this type of practice. The largest factor contributing to the need for college grade courses is the development of responsibilities in the field of constructive services to management. While the rendering of protective services is still an important responsibility of the contemporary internal auditor, his greatest value to management lies in the qualitative character of the constructive services that he may render. The extent of his value in this direction is largely in ratio to his preparatory training.

While the development of internal auditing practice has been largely in the field of private enterprise, parallel developments are now taking place in Federal government agencies. The expansion of government agencies and the complexity of their operations has developed an increasing need for the type of service rendered by the modern internal auditor. The concept of internal auditing as set forth in the "Statement of Responsibilities of the Internal Auditor,"[2] and as prevalent in private industry, coincides with the concept adopted by the U. S. Air Force.[3]

Future courses in internal auditing should give adequate consideration to this comparatively new field of service for the internal auditor. The structure and relationship of government agencies, the principles of financing and accounting that they employ, and those special features peculiar to government agencies should be covered sufficiently to acquaint the student with the basic requirements of this particular field of internal auditing.

While considerable stress has been placed on the need for a broad training in business subjects, as support for the internal auditor's technical knowledge, there is another important factor that needs to be emphasized; and that is the trainee—the individual. The degree to which a student's personal qualities are developed has an important bearing on the success he will make of his general and specialized training.

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[2] Statement approved and issued by the Board of Directors, Institute of Internal Auditors, July 15, 1947.

[3] "Internal Auditing Developments in the Air Force," Louis N. Teitelbaum, THE ACCOUNTING REVIEW, July, 1954, pp. 399–408. This article illustrates the value government agencies are attaching to modern internal auditing practice, and the pressing need for trained personnel.

The scope of current practice brings the internal auditor into contact with all classes of personnel from the president of a company down to the office boy, and from factory manager down to the line worker. In addition he is often required to work with suppliers, customers, government personnel, and others. This phase of his work calls for better-than-average contact ability. Much of his work will be concerned with critical inspections, appraisals, investigations, and similar activities, and since it is human nature to be antagonistic to a critic, the successful internal auditor must be well trained in human relations. He must be able to work pleasantly, yet effectively, with all types of personnel. Superior ability in human relations will prove to be a major factor in the advancement one makes in the business field.

Another qualification which goes hand in hand with human relations, is communications; for human relation expresses itself, largely, through this medium. Though this phase of communications is important, the internal auditor needs to be highly trained in this subject for an entirely different reason. He will have many occasions for making oral reports on his work, and will be required to conduct meetings, direct conferences, and address various groups, all of which require the ability to speak well and effectively. However, his prime need for training in communications lies in the fact that the major part of his work—the product of his professional skill—must be conveyed to management through the medium of written reports. If the written report fails to convey to management the intended message in a clear and effective manner, the auditor's value as an aid to management is substantially impaired. More auditors have failed to advance, or have been released, for deficiences in communications and human relations than because of a lack of technical ability. Lack of technical ability frequently can be overcome with a little practical experience, but it has been the experience of the author that this is not always so in the case of communications. This is a subject that needs major emphasis in all business training programs, but it is especially important to the internal auditor.

Many companies view their internal auditing department as a training ground for future executives, and for this reason select their internal auditors with considerable care, particularly in respect to their educational training.

If internal auditors are viewed as possible potential for future positions of responsibility and leadership, then a college grade course is essential. The curriculum should provide, not only appropriate courses in the necessary technical subjects, but strong basic courses designed to develop the student's personal qualities and a better understanding of the social significance of business and the important part which it plays in our complex economic society. Emphasis should be placed on subjects that stimulate the student's imagination, develop analytical ability, train him to work effectively with other people, and develop an appreciation of the social and economic problems that he will have to deal with.

To adequately meet the problems and opportunities which the field of internal auditing presents, requires a four-year program of carefully selected subjects. The freshman and sophomore years should be devoted to general or basic training and the junior and senior years to developing the student's general business and specialized subjects.

The first two years of basic training could follow closely the pattern prescribed for business administration majors. Without presuming to define the requirements for a basic course, the author is partial to a program that includes at least five of the following, with number 1 as a requirement:

1. Written and Spoken English	6 credit hours
2. Biological Science	6 credit hours
3. Physical Science	6 credit hours
4. Social Science	6 credit hours
5. Effective Living	6 credit hours
6. History of Civilization	6 credit hours
7. Literature and Fine Arts	6 credit hours

Since it is the duty of the contemporary internal auditor to review, evaluate and report on the performance of various business functions, and the adequacy of their procedures and controls, it is necessary that he be trained in as wide a range of business subjects as it is possible to provide. Rather than to pursue a few business subjects exhaustively, a better preparation for the field of internal auditing would result from a greater variety of business subjects, limited to principles, functions, and objectives. It is not necessary for the student to become *highly* trained in all business functions, but it is essential that he be well informed on what they are, how they operate, and what they are designed to accomplish. The use of company organization charts, staff manuals, and flow-charts, will help materially in attaining this objective.

It is believed that many, in considering an internal auditing course, think in terms of pure auditing only, and fail to give adequate consideration to the need of training for the many other services that are required of the present-day practitioner. Auditing principles that are common to all types of auditing can be adequately covered in one semester; and the principles and techniques peculiar to internal auditing can be covered in a following semester. But this specific training, alone, does not adequately prepare the student for the broad responsibilities he will be expected to assume.

The current needs for internal auditing may be classified as follows:

1. Four year courses arranged to fit the needs of students entering college, with the objective of training for internal auditing practice.
2. Shorter courses designed to suit the needs of business administration or accounting major graduates, who wish to take up internal auditing practice.
3. Special courses for the benefit of employed junior internal auditors, who may feel the need for further training to insure advancement in their work.

In addition to providing for a long-range training program, such as that required for the high school graduate electing to qualify for internal auditing, there is need of courses for employed business administration graduates who wish to enter the field of internal auditing. Such a course might be worked into a two- or three-semester program. The first part of the program could treat with business functions, and a review of the various business subjects covered in undergraduate courses; the second part of the program could deal with basic and common auditing principles; and the third part of the program could concentrate on the theory and practice of internal auditing techniques. Such a program might also be adapted to the needs of junior internal auditors desiring additional training.

At the present time, there is little uniformity in course contents, method of presentation, length of course, and prerequisites. However, this is a natural condition with a subject so new to college curricula. This is a problem that should be resolved at an early date. It will require close cooperation of interested colleges and the Institute of Internal Auditors; the professional practitioner, to spell out the needs; and the trained educator, to arrange the detailed program best suited to provide for those needs. Considerable progress in this direction is being accomplished through the cooperation of the American Accounting Association and the Institute of Internal Auditors.

A PROJECT REPORT OF THE 1954 TASK COMMITTEE ON INTERNAL AUDITING EDUCATION

In 1951, the American Accounting Association set up a Committee on Cooperation with the Institute of Internal Auditors. As one of its first activities, this Committee conducted a survey of college courses in internal auditing. The results of that survey were reported in the October, 1952, ACCOUNTING REVIEW.[1] Cordial relations were established with the Institute of Internal Auditors and the Committee worked with them in suggesting and reviewing material being developed by the Institute to further educational efforts in the field.

During 1954, the renamed Task Committee on Internal Auditing Education prepared and mailed to 175 colleges a comprehensive questionnaire relating to the internal auditing course, or to the coverage of internal auditing topics in general auditing and other courses in schools not offering a separate course in internal auditing.

Questionnaires were returned by 112 different schools, of which 21 reported courses being offered in internal auditing. Three schools were each offering two substantially different courses in the subject, so that a total of 24 different courses were described in the 115 questionnaires returned. In addition, 18 schools indicated serious intentions of setting up a course in internal auditing, with probable starting dates ranging from Spring Semester 1954 to the indefinite future. Four schools which had at one time offered a course in internal auditing had discontinued the course: three because of lack of sufficient student demand, and one because the material had been integrated into the general auditing course.

THE PROJECT REPORT

In view of the increasing interest in internal auditing courses evidenced by this survey, it seemed appropriate to give further thought to the place of the internal auditing course in the college curriculum, and the problems of organizing and establishing such a course, its content, and manner of presentation. After considerable individual effort and two group meetings in 1954, the Task Committee has undertaken to discuss current practice in this project report.

There are many differences in internal auditing courses in various schools. For purposes of this discussion, courses have been classified in three groups. The Committee member most familiar with each group has prepared the discussion of it which follows: Walter Meigs describes his course offered primarily to regular (full-time) college students at the University of Southern California. Ambrose Reiter considers courses offered primarily to evening (part-time) college students, such as that offered at Northwestern University. William Shors reports on his course at Butler University. This type may be offered to either of the above audiences, but is distinguished by the fact that it is taught by a series of practitioners (usually under the direction of a full-time faculty member) rather than by a single teacher, as is the case with courses in the first two groups.

Of the 24 courses reported, 12 are in the first group, offered primarily to full-time college students. Eight of these

[1] Van Voorhis, Robert H., "Internal Auditing Courses in American Colleges," ACCOUNTING REVIEW, Oct., 1952, 484–489.

were taught by full-time faculty members, while four were taught by practitioners who were either controllers or members of the executive staff of large industrial firms. Five were presented in the evening, but as part of the regular college program and primarily for full-time students.

Ten courses fall in the second group, offered in the evening primarily to part-time college students who for the most part are already employed in internal auditing or other accounting work. In several of these courses, students are required to have the usual collegiate prerequisites to junior or senior standing, but in other cases they are admitted to the course largely on the basis of interest in the subject and acceptable practical experience, regardless of prior formal education. Two courses in this group carry no college credit. Nine are taught by a single practitioner whose full-time occupation is in some phase of internal auditing or controllership, while only one is taught by a full-time faculty member.

Only two courses were reported in the third group, taught by a series of practitioners, with coordination and scheduling by a full-time faculty member. This type of course requires a concentration of firms employing internal auditors, preferably where there is a local chapter of the Institute of Internal Auditors.

The final section of this project report contains an analysis of the replies to the 1954 questionnaire, prepared by Robert Van Voorhis. There is a detailed discussion of the 24 questionnaires describing internal auditing courses. A feature of this section is a tabulation of the replies to a checklist of 26 questions indicating the extent to which internal auditing topics are covered: (1) in the 24 schools offering a specialized course in the subject, and (2) in the general auditing or other courses in 84 schools not having an internal auditing course.

It should be noted that Earle Cunningham developed most of the checklist questions, helped plan the current project, and contributed to Committee activity in many ways, although he did not contribute a section to this report. His views are expressed in the article immediately preceding in the REVIEW, "The Need for College Courses in Internal Auditing," which is designed to complement this project report.

I. COURSES OFFERED PRIMARILY TO REGULAR COLLEGE STUDENTS—THE UNIVERSITY OF SOUTHERN CALIFORNIA

In view of the present crowded condition of the undergraduate accounting curriculum and the much-discussed dangers of excessive specialization, a recommendation for the addition of a new course such as internal auditing cannot be given in a light or casual manner. If such a recommendation is to receive serious consideration, compelling arguments must accompany the proposal. It therefore seems appropriate that before detailing the plans for operation of a course in internal auditing, we should consider briefly the principal arguments for training in this field.

We live in an era of giant business concerns. The productive and distributive superiority of the United States has been achieved in large part through the development of gigantic corporate enterprises. It is now a commonplace finding that three or four concerns account for the bulk of the output of such industries as automobile manufacture, meat-packing, tobacco, aluminum, sugar-refining, and a host of others.

As the large corporation becomes a more and more significant element in our economy, internal auditing is receiving increased recognition as a valuable aid to top corporate management. The larger the enterprise, the greater is management's need for a full-time staff of investigators and analysts qualified to appraise

and report on accounting, financial, and operating activities throughout the organization. This investigating and reporting service guards against the inefficiency, confusion, and duplication of effort which tend to arise when organizations grow so large that top management is far removed from the details of current operations.

While emphasizing the importance of internal auditing work in large corporations, it is necessary to bear in mind that even in quite small concerns many of the functions which comprise internal auditing must be performed by someone. In many firms not large enough to utilize an internal auditing department, or even the services of a single full-time auditor, certain internal auditing functions are performed by the manager or someone designated by him. The significance of internal auditing is most clearly apparent when viewed against the backdrop of the giant corporation, but an understanding of the objectives and techniques of internal auditing can be very useful to management in concerns of all sizes.

A very large proportion of the current graduates of collegiate schools of business will affiliate themselves with large corporate organizations. As these men rise to positions of responsibility, regardless of the particular type of operations under their direction, they will benefit from an understanding of the company-wide activities of the internal auditor and the utilization of those activities by top management in achieving efficient administration of the entire enterprise. Internal auditing may well become as indispensable a tool of corporate management as cost accounting or budgeting. Today's business administration students will be aided in their transition into the executives of tomorrow by gaining an understanding of the techniques of controlling large corporations.

It should be apparent from the preceding discussion that a course in internal auditing may be worthwhile for business administration students in general rather than being limited to accounting majors. A decision on this point will, of course, exert a major influence on the content of the course. Some universities have developed internal auditing courses which are essentially extensions of the general course in auditing, and which are restricted to senior accounting students with extensive background in accounting theory, cost accounting, auditing, and budgeting. Other institutions offer courses in internal auditing which serve to integrate the accounting curriculum with other divisions of business administration, and which have as prerequisites only the introductory course in accounting. The latter type of course is obviously not intended to train students for employment as internal auditors, but rather to augment their understanding of and preparation for managerial responsibilities.

Some schools of business which do not offer a course in internal auditing explain that the subject is adequately covered in the general auditing course. This statement is significant in that it denotes a growing awareness of the importance of internal auditing, since admittedly a few years ago standard auditing textbooks contained only fleeting references to the activities of internal auditors. The approach of these schools to the issue of including internal auditing in the cirriculum is also significant in that the general auditing course is almost universally limited to accounting majors. An implicit assumption may exist in such an approach that the work of the internal auditor is, after all, not very different from that of the independent public accountant. The fallacy of this assumption has been emphasized by nearly all authorities in the literature of internal auditing. The inclu-

sion of material on internal auditing in the general auditing course is, however, in the opinion of the writer, to be commended rather than discouraged. It seems highly desirable that every university graduate in accounting be aware of the role of internal auditing in the modern corporation, for he is certain to encounter internal auditing activities regardless of the accounting work he undertakes.

The real issue at the moment would appear to be not the desirability of including material on internal auditing in the general auditing course, but rather the desirability of making available to all business administration students some knowledge of this activity which is part and parcel of the technique of administration of large scale enterprises.

One interesting alternative to the creation of a course in internal auditing lies in the use of a course in controllership. If this latter course is presented in terms of the managerial utilization of accounting data and internal controls, it may appropriately include many of the concepts stressed in internal auditing.

One of the principal handicaps which have prevented internal auditing courses from being more rapidly adopted in university curricula has been the relative scarcity of text material. Considerable progress has been made in recent years in developing both textbooks and case materials, but much remains to be done before it can be said that the available materials are truly adequate. Among the more widely-used text materials are the following:

F. A. Lamperti and J. B. Thurston, *Internal Auditing for Management*. (New York: Prentice-Hall, Inc., 1953. Pp. x, 500. $7.95)

W. A. Walker and W. R. Davies, *Industrial Internal Auditing*. (New York: McGraw-Hill Book Company, Inc., 1951. Pp. vii, 329. $6.00)

The Institute of Internal Auditors, *Case Problems in Internal Auditing and Control*. (New York: Prentice-Hall, Inc., 1952. Pp. vi, 74. $1.25)

In addition to the *Case Problems* listed above, an *Instructor's Manual for a College Course in Internal Auditing* has been compiled by the Institute of Internal Auditors along with other studies and reports, including a student booklet available gratis, *The Field of Internal Auditing*. These materials may be obtained from the Institute at 120 Wall Street, New York 5, New York,

An internal auditing course offered primarily to regular college students will presumably be taught in most cases by a regular member of the accounting faculty. To assure close co-ordination with the best of current practice, it seems desirable to bring to the classroom for occasional lectures representatives of internal auditing departments of large corporations. The Institute of Internal Auditors is anxious to cooperate in such arrangements. The use of the periodical, *The Internal Auditor* (available to students at $1.00 per year), and visits to chapter meetings of the Institute will also aid in this respect. Summer employment of the instructor on the internal auditing staff of a carefully selected corporation is particularly helpful and can often be arranged. In contrast with courses offered to evening college students, however, the writer feels that an internal auditing course offered primarily to regular college students should place less emphasis on "how-to-do-it" procedures and more emphasis on the objectives of internal auditing, its place in the corporate structure, and its contribution to effective management. Emphasis on the writing of internal audit reports based on longer problems and cases may be of particular value to the university student in developing his capacity for analysis and clear, forceful expression.

II. COURSES OFFERED PRIMARILY TO EVENING COLLEGE STUDENTS—NORTHWESTERN UNIVERSITY

A semester course in internal auditing is offered by several universities and colleges throughout the country to part-time college students. Classes meet generally once a week for two hours over a period of sixteen weeks. Credit of two semester hours is usually given.

Prerequisites may or may not include a course in auditing principles. Where the greater background is required, it is believed that the student can comprehend more fully the objectives, principles and procedures of internal auditing and can better understand how the work of the internal and external auditor may complement each other. Such a background permits the instructor to cover more effectively a wider range of specific subjects or types of functional audits.

At most of the schools offering such a course to part-time college students, the instructor was actively engaged in internal auditing work. It is significant to note that at the present time the majority of these classes in internal auditing are taught by internal audit staff personnel of United States Steel Corporation. In fact, in schools in which this plan is in effect the original suggestion to institute such a course came from the Steel Corporation with an offer to supply the teaching personnel. Such an arrangement is feasible only in an area in which the Steel Corporation has men available to assume these responsibilities. In other areas the local chapter of the Institute of Internal Auditors can be of valuable help in recommending teaching personnel and in finding individuals to lecture on special topics in the field of internal auditing.

Courses offered under these circumstances are under the direct supervision of the school. No special status applies. The person teaching the course is employed and compensated by the school, the course is listed as a regular offering of the school with the school determining the prerequisites. The cooperation of the Institute of Internal Auditors in promoting such a course should be sought.

In each instance where the course is taught by United States Steel Corporation personnel, the text used is *Industrial Internal Auditing* by Walker and Davies (McGraw-Hill, 1951). The authors are likewise United States Steel personnel. This text has served well in the course in Internal Auditing as offered at Northwestern University. It should be noted that other good texts are presently available.

A list of suggested additional readings, including the *Internal Auditor*, quarterly journal of the Institute of Internal Auditors, is supplied to students at the beginning of the course.

The text material is supplemented to a considerable degree by the presentation of actual auditing experiences of the instructors and of class members engaged in this work. In fact such illustrations are a vital factor in showing the applicability of the principles to varying conditions met in business operations. These actual cases stimulate class discussions and an interchange of ideas, which has an appeal to students.

In the conduct of the course the instructor may present guest lecturers. At Northwestern University, it has been the practice to present both United States Steel internal audit staff specialists and management personnel. Specialists may discuss functional audits of sales offices, traffic and transportation costs, construction contract accounting, government regulations as they affect the company, and payroll incentives. Management personnel lecture on the value of internal auditing as an aid to management.

Homework assignments include problems and cases included in the text of

Walker and Davies, or drawn from the publication of the Institute of Internal Auditors entitled *Case Problems in Internal Auditing and Control* (Prentice-Hall, 1952) or prepared by the instructor from situations encountered in daily activities. Tests of the students' work include mid-term and final examinations.

III. COURSES TAUGHT BY A SERIES OF PRACTITIONERS—BUTLER UNIVERSITY

A course in Internal Auditing was offered at Butler University in the academic years 1950–51 and 1952–53 with an average enrollment of 30 students, who had varied backgrounds in accounting training and experience. The majority of the members of the class had previous training in general accounting and auditing. About 50% of the group were seniors majoring in accounting and the rest, graduates of other colleges, who were employed in the accounting departments of various Indianapolis business firms and a small number from public accounting firms. Since the course was offered as part of the evening division curriculum, it was possible to attract students from outside of the regular student body.

The Indianapolis Chapter of the Institute of Internal Auditors cooperated in the planning of the subject matter of the course and, in addition, provided guest lecturers. The course plan followed closely the outline in the *Instructor's Manual* prepared by the Institute of Internal Auditors. Minor changes in sequence of subject matter and emphasis were made. The Chapter's Committee on Education worked very closely with the professor in charge of the course. Special lecturers from the members of the local Chapter were selected in accordance with their ability to present particular topics, i.e., an internal auditor from a public utility presented the subject of Internal Auditing of Fixed Assets. All the guest lecturers presented a basic outline and in some cases their complete text and case problems to the instructor in charge of the course, who reviewed the material from the point of view of proper correlation with his own lecture. A conference was held with each guest lecturer prior to his presentation, in order to aid and guide him in the preparation of his material.

A number of problems were encountered in connection with the obtaining and guidance of the guest lecturers. Many well qualified members of the local chapter were hesitant about appearing before college classes, because of a lack of confidence, which was found to be entirely unwarranted. This hesitancy was overcome by personal conferences between instructor and lecturer during which time a basic outline of the subject was prepared and suggestions were made as to how the material was to be presented to the class. Suggestions were also made as to the use of illustrations, cases, and visual aides. The net result of the preliminary conferences was the development of confidence and a very effective class presentation.

On the average, 12 different lecturers appeared before the class. They represented a comprehensive cross-section of the industries in the Indianapolis industrial area.

The procedure followed each evening consisted of a lecture by the instructor and a class discussion of the appropriate case problem selected from the Institute's *Case Problems In Internal Auditing And Control.* This was followed by the guest lecturer on the same subject, who described application to the problem as it occurred in the auditing activities of the industrial concern which he represented.

At the conclusion of the course several guest lecturers appeared, as a panel, to answer written questions which had been presented by the students and to discuss and answer questions from the floor.

The final examination consisted of a small number of essay questions and a major emphasis on typical internal auditing cases. Many of the latter were supplied by the guest lecturers and were based on problems which had occurred in their own businesses.

The experience of Butler University indicates that this type of cooperative plan makes possible a very practical and effective internal auditing course.

IV. THE 1954 INTERNAL AUDITING QUESTIONNAIRE

A seven-page questionnaire was prepared by the Task Committee on Internal Auditing Education and mailed to 175 colleges offering programs in accounting, soliciting information on internal auditing courses. For those colleges not offering such a course, a substitute one-page questionnaire was enclosed, with the request that these schools also fill out the last two pages of the longer questionnaire (Section G: Course Content and Objectives), which contained a list of 26 questions concerning internal auditing topics. Schools offering the course were asked to indicate the coverage of these topics in their internal auditing course, while schools not offering an internal auditing course were asked to indicate coverage of these same topics in their general auditing or other courses.

ANALYSIS OF 24 INTERNAL AUDITING COURSES

Completed questionnaires were received from 21 different colleges offering courses in internal auditing. Three of these schools each offered two substantially different courses, making a total of 24 courses about which comprehensive data were obtained.[2] These data are discussed in the same general order that the questions appeared in the long questionnaire.

Section A. General

In 15 cases, the course bears the title of Internal Auditing. Other titles include Industrial Internal Auditing (3), Internal Auditing and Control (2), Internal Auditing and Controllership (2), Internal Control and Auditing, and Internal Auditing and Internal Control. Catalog descriptions vary widely.

Course credit hours are as follows:

Credit	*Courses*
2 semester hours	6
3 quarter hours	3
4 quarter hours	1
3 semester hours	7
4 semester hours	3
6 quarter hours	1
no credit	2
not indicated	1

Hours in class varied considerably, ranging from a low of 8 hours in class per semester hour of credit to a high of 15 hours in class per semester hour of credit. Presumably this represents the normal variation between schools in this respect and is not a difference applying primarily to the internal auditing course. The two non-credit courses required 30 and 32 hours of class attendance, and the one with credit not indicated required 30 hours. Only three schools have regular laboratory periods; the others devote the entire class time to lecture and recitation.

Four schools offer the course twice a year, 17 offer it once a year, and in the remaining 3 it is given every other year. In 7 schools the course is regularly open to juniors, and with permission in another; in

[2] The colleges offering these 24 internal auditing courses are: University of Alabama; University of Alabama, Extension Division, Birmingham Center; Brigham Young University; Butler University; University of California, Los Angeles Extension Division; University of California, San Francisco Extension Division; College of the City of New York, 2 courses; Columbia University; Duquesne University; Fenn College; George Washington University; Long Island University; Michigan State College; University of Minnesota; Northwestern University; Ohio University; Ohio State University; University of Pennsylvania, Wharton School; University of Pittsburgh; San Diego State College; Sienna College; University of Southern California; and University of Utah.

13, it is regularly open to seniors, and with permission in 2 others; in 4, it is open only to graduates; in 1, graduates may take the course only without credit; 2 evening courses are apparently open to all students qualified by practical experience or otherwise, regardless of class standing.

In 17 schools, the course is offered in the regular college program, with 6 of these classes held regularly in the evening. In 5 schools the course is offered through the extension division for college credit, and in 2 by the extension division without credit.

There is some uncertainty concerning the earliest date courses were offered in the various schools, but the following tabulation is approximately correct:

1941	1
1947	2
1948	3
1949	3
1950	4
1951	2
1952	5
1953	3
1954	1

Three additional courses were planned to be introduced in 1954.

Over 1,750 students have been enrolled in 22 of the courses. Two of the largest schools which have offered the course longest made no estimate of the number taught. In the school year 1953–54 approximately 450 students were enrolled in internal auditing courses. In 12 schools no students other than accounting majors are permitted to take the internal auditing course. In 6 schools it is open to general business students, and requirements in other schools vary. The accounting courses a student is presumed to have completed before entering the internal auditing course differ somewhat between schools, but in most cases students are expected to have completed a course in general auditing.

Section B. Instruction Material

Several different books were used as texts (in some cases more than one to a course) as follows:

V. Z. Brink, *Internal Auditing*. The Ronald Press Company, 1941.	6
V. Z. Brink and B. Cadmus (Ed.), *Internal Auditing in Industry*. The Institute of Internal Auditors, 1950.	1
J. B. Heckert and J. D. Wilson, *Controllership*. The Ronald Press Company, 1952.	1
Institute of Internal Auditors, *Case Problems in Internal Auditing and Control*. Prentice-Hall, 1952.	8
F. A. Lamperti and J. B. Thurston, *Internal Auditing for Management*. Prentice-Hall, 1953.	6
W. A. Walker and W. R. Davies, *Industrial Internal Auditing*. McGraw-Hill Book Company, 1951.	13

In most cases, supplemental readings are assigned or recommended in the *Internal Auditor* and other accounting periodicals, the Institute of Internal Auditors conference papers, and auditing and internal auditing works other than those used as texts.

Problem materials come mainly from three sources: the *Case Problems in Internal Auditing and Control*, which contains 55 situations requiring thoughtful but not numerical answers; four longer numerical audit-situation case problems in Walker and Davies' *Industrial Internal Auditing;* and cases and problems developed by individual instructors for their own use. Opinion generally seems to be that the published materials are suitable, but that more of each variety should be published. There is also some feeling that there is a need for published problems involving numerical manipulations but somewhat shorter than the Walker and Davies case problems.

Section C. Teaching Personnel

In summarizing the section on teaching personnel, it seems appropriate to use the same grouping of courses as that followed in the three preceding sections of this project report.

Teachers of the 12 courses offered primarily to regular college students include 4 professors, 3 associate professors, 1 assistant professor, and 4 part-time instructors employed as controllers or on the executive staff of large industrial firms. Teaching experience of the faculty persons ranged from 7 to 31 years, while practical experience for this group in public, private, or governmental accounting or in various business capacities ranged from 5 to 32 years. Teaching experience of the part-time instructors employed in industry ranged from 3 to 20 years. In many cases the same instructor has taught the internal auditing course ever since it was first offered in his school.

In the 10 courses offered primarily to evening college students, 9 of the instructors were employees of industrial firms (and of these, 8 came from the United States Steel Corporation, which has been active in encouraging internal auditing courses) and 1 was an assistant professor. Teaching experience of the practitioners ranged from 2 to 10 years, while the faculty member had 10 years of teaching and 5 years of practical experience.

Of the faculty members in charge of the courses taught jointly with a series of practitioners, one is a professor with 25 years teaching and 5 years practical experience, and the other is an associate professor with 8 years teaching and 1 year practical experience. No data were obtained on the various practitioners taking part in these courses.

Guest speakers are invited to address several of the twelve courses offered to regular college students, ranging from 1 to 4 per course. Speakers include internal auditors, members of controllers departments, and responsible business executives in other fields.

In most of the 10 courses offered primarily for evening college students, the instructors brought in one or more executives in various phases of company operation, such as budgeting, cost accounting, purchasing, traffic, and industrial engineering; and in some cases, accounting professors appeared as guest speakers.

There were no laboratory assistants or graders used in any of the 24 courses reporting.

Several unusual teaching features are used. In one school, student panels have been used to good effect in presenting material.[3] A variation of the panel idea used in one class has two students report the results of an audit or investigation to the class, which acts as a board of directors and questions the two students reporting the results of their work. In many cases, the instructors are able to bring to class actual cases from their experience, to stimulate thought and discussion. In one course, a simulated petty cash count and other "props" are used.[4]

Section D. Conduct of Course

Class meetings vary in number from one to three per week, with total class time per week from 100 to 180 minutes. Lecture and class discussion occupies the bulk of the class time in all courses, with varying amounts spent in some cases on student presentations and laboratory work.

Visual aids other than blackboards are used occasionally in twelve of the courses. These include industrial training films, company annual reports, flow charts and problem solutions, magazine articles and other published materials, and cases and forms from actual practice.

There is no local chapter of the Institute of Internal Auditors within visiting distance of 5 of the schools. In 10 of the 19 cases where there is a nearby chapter, the students do not visit it at all. In the other 9 cases, students visit individually or at-

[3] This is described in: Frank A. Lamperti, "A Neophyte Teaches School," *Internal Auditor*, Sept., 1951, pp. 38–47.

[4] These are described in: Robert H. Van Voorhis, "The Use of 'Props' in Teaching Accounting," ACCOUNTING REVIEW, January, 1954, pp. 285–286.

tend chapter meetings as members. In no case reported has a class attended a chapter meeting as a group. Only two of the classes made field trips to observe actual practice; these made 1 trip each.

In only 3 courses open both to undergraduate and graduate students is more work required of the graduates. The additional work in these cases consists of additional reading, practical problems, and reports.

In 12 courses, students are required to develop theoretical audit programs as part of their problem work.

Section E. Student Homework Assignments

Pages of reading required of students per hour of class attendance range from 8 to 25. Estimates of time spent on required problem work ranged from 6 to 110 minutes per class hour, with a majority of cases requiring approximately 30 minutes per class hour. It is recognized that the time required to read and work problems varies considerably from one student to another, so that these time estimates are only rough approximations.

In every course, problem assignments are graded by the instructor. In all but 4 cases, graded problems are returned to the students and are discussed in class. Returned problems are retained by the student in most cases. In only two courses are key problem solution figures given to the students in advance. In most cases where the problems are returned and discussed in class, the solution (or various possible acceptable solutions) is brought out in the discussion or otherwise given to the student after he has completed his work.

Section F. Tests and Examinations

In 5 courses no tests are given during the term, and in one there are neither tests nor final examination (this course carries no college credit). In 6 courses there is 1 test; in 10 courses, 2 tests, in 2 courses, 3 tests; and in 1 course, 4 tests. The tests commonly run the length of the class period. This gives a range of from 1 to 6 hours devoted to testing during the term for those courses requiring such tests. Length of the final examination ranged from 90 to 240 minutes.

Test and examination questions of the objective type are used in 14 courses, comprising from 20 to 100 per cent of the total; numerical problems are used in 8 courses, comprising from 10 to 60 per cent of the total; and case problems are used in 16 courses, comprising from 10 to 100 per cent of the total.

Section G. Course Content and Objectives

In this section, 26 questions were posed, relating to coverage of selected internal auditing topics in the course. Blanks were provided for checking coverage of each topic, under headings of Fully," "Briefly," and "Not at All." These answers are of course not strictly comparable, depending partly on the interpretation given to the question by the reader and partly on his interpretation of the degree of coverage implied by the three available headings. These, and perhaps other, shortcomings should be kept in mind in studying the tabulation (p. 68) of the 24 replies from schools offering a course in internal auditing, in comparison with the replies from 84 schools not offering a course in internal auditing, which answered the same questions in regard to their general auditing and other courses.

91 OTHER REPLIES TO QUESTIONNAIRE

Replies were received from 91 colleges which were not then offering a course in internal auditing. Of these, 18 plan to introduce such a course, 3 during the year 1954 and the rest at later dates, awaiting sufficient student demand or planning ahead for the indefinite future.

Four of these 91 colleges had previously offered a course in internal auditing and had discontinued the course. In 3 cases, it

Key to Coverage: A. Fully; B. Briefly; C. Not at All; D. Not Checked	This Item Covered: 24 Courses			84 Colleges Without Course			
	A	*B*	*C*	*A*	*B*	*C*	*D*
1. Are the objectives of internal auditors and public accountants clearly defined and distinguished?	23	1		45	37		2
2. Are the responsibilities of internal auditors and public accountants clearly defined and distinguished?	22	2		44	38		2
3. Is consideration given to the relationship of the internal auditor to the public accountant, and the coordination of their audits?	22	2		39	45		
4. Is consideration given to preparation of internal audit working papers, and their importance to the public accountant?	12	11	1	9	53	21	1
5. The terms "internal control," "internal check," and "internal audit" are sometimes confusing. Are these clarified and defined?	22	2		51	31	2	
6. The terms "systems," "methods," and "procedures" are frequently used with little distinction in meaning. Are these clarified and defined?	13	9	2	33	31	17	3
7. Is there stress on the need for a broad business knowledge to supplement specialization in auditing mechanics?	19	4	1	48	28	4	4
8. To determine the extent of verification needed, are students instructed in making scientific reviews and in the art of skillful testing?	8	12	4	22	49	8	5
9. Is distinction made between pre-auditing and post-auditing, and the internal auditor's responsibility in respect to pre-auditing activities considered?	17	7		22	46	15	1
10. Are communications and report writing stressed?	15	8	1	31	45	7	1
11. Are human relations and interviewing stressed?	13	11		22	40	18	4
12. Is it pointed out that the pure mechanics of auditing are only a small phase of the modern internal auditor's responsibility?	21	2	1	33	44	6	1
13. To what extent is the instruction built around the balance sheet and profit and loss accounts?	8	12	4	47	17	12	8
14. Is functional auditing rather than account auditing emphasized?	20	3	1	19	49	11	5
15. Is the history and development of internal auditing covered?	12	9	3	3	35	45	1
16. Are the two general phases of the internal auditor's work—protective and constructive service to management—emphasized and distinguished?	24			19	46	17	2
17. The internal auditor's responsibility is governed largely by the level of his appointment. Are various possible levels considered?	13	11		12	33	38	1
18. Is the student instructed in the internal auditor's responsibilities in respect to company policies, systems, methods, and procedures?	21	3		10	48	23	3
19. Is attention given to the value of an internal auditor as a liason between top management and line workers?	20	3	1	10	39	30	5
20. The internal auditor's responsibility often includes the making of reviews and evaluations, surveys, and special investigations. Are the nature, scope, and procedures for such assignments considered?	19	5		7	32	42	3
21. Are the differences in the duties and responsibilities of the traveling internal auditor and the resident internal auditor developed?	8	11	5	4	23	56	1
22. Is there included instruction in the preparation and use of the several types of internal audit reports?	9	12	3	5	18	59	2
23. Is there consideration of the follow-up procedures of the internal auditor's report?	12	10	2	5	22	54	3
24. Is it made clear to students that the internal auditor has no authority to issue orders, directives, or other instructions, except as may be specifically granted him?	21	3		16	33	33	2
25. Is the student informed of the internal auditor's right and duty to express his opinions, recommendations, and suggestions?	19	5		14	43	26	1
26. Is consideration given to the ethics of internal auditors?	16	7	1	13	32	36	3

appeared that there was insufficient student demand for the course, which was an elective, and therefore in competition for limited student time with other elective courses. One of these three schools continues to list the course in its catalog and is prepared to offer it again if demand for it increases. The fourth school has decided that internal auditing is not a suitable subject for a separate undergraduate course and has integrated the internal auditing topics into the general auditing course.

Of the remaining 70 colleges, many appear convinced that there is adequate coverage of internal control and internal auditing in the general auditing course, and therefore no need for a separate course. Many others appear to give little or no time to the subject, however. There was a considerable diversity of comment in response to the question concerning the time spent in other courses and the internal auditing topics covered. For example, one person stated: "Not possible to separate general auditing and internal auditing time, as I feel there is little difference either as to purposes, objectives, procedures, or methods." Another said, "Internal auditing is a branch, or subdivision, of general auditing and its internal control aspects. It is too procedural." A third comment, "Hard to estimate in the various courses, but it is considerable. Internal auditing is an inseparable part of the work in Auditing, Accounting 411–412. Consideration of it must always be present." It seems evident from these and other replies to the questionnaire that there is a considerable difference of opinion as to what internal auditing really is, and as to where, how, and to what extent (if at all) it should be covered in college courses.

Included in both the questionnaire answered by colleges offering courses in internal auditing and in the one answered by colleges not offering the specialized course, was a checklist of 26 questions relating to the coverage of internal auditing topics. Answers to these questions for both groups of schools have been tabulated above.

FINAL COMMENT ON QUESTIONNAIRES

Problems of devising and wording questions which will be understood and answered consistently are well known. The Committee has attained no perfection in this respect, and it seems probable that some of the questions were misunderstood by some of those answering, and that some of the answers were misunderstood by the Committee. Questionnaires do not always reach the persons intended by the senders, and coverage is therefore less complete than expected. It is probable that there are schools offering courses in internal auditing other than those included in the 24 replies received by the Committee. (If there are, the Committee would like to learn of them.) Some persons receive so many questionnaires that they are unable or become unwilling to answer them. There were probably some who felt, as one recipient replied, "We do not any more answer such questionnaires."

In spite of the shortcomings of the questionnaire method, it appeared to offer the only opportunity for our Committee, with its limited personnel, time, and resources, to obtain information on internal auditing courses and topic coverage from colleges and teachers in all parts of the country. The Committee sincerely appreciates the cooperation it has received from so many persons in carrying out this project.

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WALTER B. MEIGS, University of Southern California
AMBROSE M. REITHER, Northwestern University
WILLIAM F. SHORS, Butler University
ROBERT H. VAN VOORHIS, Chairman, University of Alabama

COMMENTS ON NETER'S "PROBLEMS IN EXPERIMENTING WITH THE APPLICATION OF STATISTICAL TECHNIQUES IN AUDITING"

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In the first section of the Neter[1] paper under the heading, "Inadequacy of Some Experiments in the Past," he lists certain sample checks by Vance and also by Smith. The comment is, "The reason for their lack of significance is that the experiments do not establish the relevance to the purpose of the audit, etc." We find the further comment, "This approach of working with an isolated phase of an audit was probably followed because it is much simpler than an attempt to tackle the audit as a whole."

These statements indicate a misunderstanding of what was actually done. In the case of the Smith report the audit as a whole for the municipality was well established over a period of ten years before the case studies were begun. The purpose behind the report was to indicate how cases do occur during an audit where samples as a basis for judgment are both adequate and efficient. I am quite sure that the cases given by Vance also followed due consideration of the audit as a whole.

Mr. Neter is correct in the view that the audit should be planned before sample checks are taken. Since this was done in case of the experiments in question, we should say that they are adequate for the purpose served. Some of the general considerations in planning the audit are restated, such as account balances and internal control. No cases are given to indicate how he would make tests.

The writer is now planning a complete report of an audit somewhat as follows:

1. Plan the audit as a whole.
2. Make the checks which do not require a statistical sample.
3. Take appropriate samples when needed as basis for judgment.
4. Report the outcome of the various observations and give a proper opinion of the results.

A report of this character should clarify something relative to the use of statistical methods in auditing.

[1] Accounting Review, October, 1954, pp. 591–600.

THE FUNDS STATEMENT AS AN INTERNAL REPORT TO MANAGEMENT

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IN A PRECEDING ARTICLE we have reported some of the results of an extensive survey of funds statement practices in the United States and Canada.[1] This survey was conducted with a sample of 500 industrial corporations. Fifty-eight per cent of the companies responded to the questionnaire, and of these, 197 companies or 68 per cent stated that they used the funds statement. Of these 197 companies only 37 prepared the funds statement for inclusion in stockholders' reports. The great majority thus used the funds statement only as an internal report. In this capacity the funds statement has developed into a useful tool for problem solving of financing requirements. Further, not only was the funds statement prepared for internal reports, but active use of it was indicated in the great majority of the 197 companies.

OBJECTIVES

Table I shows the objectives which were stated by the companies to be the most important in the preparation of funds statements for managerial use. Financial reporting was the most frequently mentioned objective for the use of the funds statement as an internal report. However, the use of the funds statement as an important planning device was a close second. The need to explain the function and use of profits to company managements was not as widely felt as in the case of funds statements included in reports to stockholders.

FUNDS STATEMENTS AS PLANNING DEVICES

These findings are reinforced by answers to questions about the use made of historical and projected funds statements in making financial decisions. Sixty-four per cent of the companies using the funds statement as an internal report, or 123 companies, stated that they have used funds statements of past periods as aids in making current financial decisions. Sixty-eight per cent of the companies using the funds statement as an internal report, or 131 companies, have used projected funds statements as aids to decision-making. Of these companies, 94 stated that they have used both historical and projected funds statements. The use made of the funds statement as an aid to decision-making parallels the stated objective of 145 companies that this statement is to be used to help company officials make decisions. Table II illustrates the data given in this paragraph.

Usage in Decision-making by Size of Company[2]

As was expected, the largest companies reported the greatest percentage of use, 93 per cent; but there was a high percentage of use, around 80 per cent, in each size group. All the companies, except those with total assets under $5 million reported slightly more extensive use of projected funds statements than historical funds

[1] Anton, H. R., "Funds Statement Practices in the United States and Canada," ACCOUNTING REVIEW, October, 1954, pp. 620–627. The survey was conducted under the auspices of the Bureau of Business Research, University of Washington.

[2] Companies were subdivided into five groups: Group A, companies with total assets over $100 million; Group B, companies with total assets between $50 and $100 million; Group C, companies with total assets between $10 and $50 million; Group D, companies with total assets between $5 and $10 million; and Group E, companies with total assets under $5 million.

TABLE I

OBJECTIVES STATED FOR THE INCLUSION OF FUNDS STATEMENTS IN REPORTS TO MANAGEMENT*

	No.	Per Cent
Number of companies preparing funds statements for their managements (including boards of directors)	192	100
Objectives stated:		
(1) To report financial changes not readily seen in either the balance sheet or the profit and loss statement	166	87
(2) To help make financial decisions by company officials and directors (including future planning and capital expenditures)	145	76
(3) To explain the functions and use of profits to company officials and directors	90	47
(4) To illustrate the financial strengths and weaknesses of the company	73	38
(5) Miscellaneous	4	2

* Compare with Table VI in previous article. See footnote 1 for reference.

statements. The smallest-size group favored the use of the historical statement by 74 per cent to 48 per cent. Primarily this is due to less exacting demands for formalized planning in the smaller company, but may be due to other circumstances as well. The smaller-company's executive's ability to keep in close contact with the business tends to make more elaborate devices unnecessary. As was noted in the survey, small companies rely heavily on funds statement presentation to bankers. Thus the funds statement is of primary value to them for short-term credit requests. It is probably safe to assume also that the small company's expansion is due less to prospective profits than it is a resultant of the *fait accompli*. If funds are available from *past* operations, the company will expand; if there are no such funds available, it will not. This is, of course, quite the opposite of the generally conceived theory that anticipations elicit activity.[8]

[8] But see the "*Minneapolis Project*," Investors Diversified Services, Inc., Minneapolis, Minnesota, 1950, p. 17 and p. 28 ff., for support of our contention.

TABLE II

THE FUNDS STATEMENT AS A PLANNING DEVICE

	Number of Companies	Per Cent
Total number of companies using the funds statement as an internal report	192	100
Companies Using Historical Funds Statements		
Funds statements of past periods alone have been used by managements in helping to make current decisions in companies totaling	29	
Funds statements of both past periods and projected for future periods have been used by managements in helping to make financial decisions in companies totaling	94	
Total	123	64
Companies Using Projected Funds Statements		
Funds statements projected for future periods alone have been used by managements in helping to make financial decisions in companies totaling	37	
Funds statements of both past periods and projected for future periods have been used by managements in helping to make financial decisions in companies totaling	94	
Total	131	68
Total companies using funds statements for decision-making purposes	160	83

The use of historical and projected funds statements for decision-making by size of company is illustrated in Table III.

TABLE III

FUNDS STATEMENT USAGE IN DECISION-MAKING
(By Size of Company)

	Percentage of Use				
	A	*B*	*C*	*D*	*E*
Type of Statement used:					
Historical	80%	50%	55%	77%	74%
Projected	83%	64%	66%	83%	48%
Both used	70%	51%	42%	66%	37%
Total usage*	93%	73%	79%	94%	85%

* Usage in decision making, as a percentage of all companies in each group that use the funds statement.

Historical Funds Statements

The majority of the companies using the funds statement as an internal statement and tool for decision-making regard it as strictly a short-term tool. Table IV shows that single historical funds statements for periods of less than one year were used in 31 per cent of the cases. Series of funds statements each for less than annual periods were used 41 per cent of the time. Further, single funds statements for annual periods were used in 37 per cent of the cases. The use of short term statements is thus high.

In contrast to this, the 5-year cumulative funds statements were used in only 11 per cent of the cases, and the 10-year cumulative funds statements were used in only 4 per cent of the cases. If we assume that series of annual funds statements are used for long-term analysis, as much as 50 per cent of the statements may be used for long-term analysis. The low proportion of 5- to 10-year statements used plus comments from the respondents seem to uphold the fact that the funds statement has been used mainly as a guide to short-run decisions.

Projected Funds Statements

On a projected basis, the funds statements again were used preponderantly in the short-run. However, a stronger case was made for longer-run projections than for long-run historical statements. For 5-, 10-, and 20-year projections, the respective percentages of use are 18, 4, and 1 per cent. This is a total of 23 per cent for projections of 5 years or longer. If we add the projections of series of annual funds

TABLE IV

TIME PERIODS OF USE FOR FUNDS STATEMENTS USED IN MAKING DECISIONS

	Historical Statements		*Projected Statements*	
	No.	*Per Cent*	*No.*	*Per Cent*
Very short-term:				
(1) A single funds statement for a period of less than one year	38	31	44	34
(2) A series of funds statements for periods of less than one-year including year-to-date	52	40	32	24
Short-term:				
(3) A single annual funds statement	46	37	57	44
(4) A series of funds statements on an annual basis	43	35	42	32
Longer-run:				
(5) Five-year cumulative funds statements	13	11	23	18
(6) Ten-year cumulative funds statements	5	4	4	4
(7) Twenty-year cumulative funds statement	0		1	1
(8) Various funds statements prepared for various periods as the problem warrants	11	9	4	3
Cases	123	100	131	100

statements which were used in 32 per cent of the cases, a 55 per cent total is obtained. It is probable, however, that the great majority of the projections do not go beyond a five-year period, and a substantial number do not go beyond a one-year forecast.[4]

The projected funds statement is in many ways dependent on over-all budget projections of the company. There is the tendency, then, for companies that prepare projected funds statements to be those that make use of budgets, and vice versa. Moreover, funds statements were frequently used as measures of control. Some companies, for example, prepared their funds statements on an actual vs. projected basis to check attainment of plans. In some cases the actual was then used as a modifying element for the next projected statement. Other companies used a continuing series; one, three, and five-year projections, with each successive projection being more tentative. Outlay projects (capital expenditures mostly) would then be ranked accordingly: "must-be-done," "second-in-importance," "marginal," and "to be undertaken only in view of more current circumstances." In this way essential planning was kept active. The projected funds statements would be modified over time as data for each successively closer period became more definite. In this way a constant review is offered. The statement itself, of course, is a technique whereby the data for capital rationing are obtained.

RECONCILIATION WITH BUDGETS

Companies using the funds statement as an internal tool of management attempted to reconcile it with the various budgets or other anticipatory statements in many cases. Table V shows the extent of this practice.

TABLE V

FUNDS STATEMENTS—RECONCILIATIONS WITH VARIOUS BUDGETS

	No.	Per Cent
No. of companies where funds statements were used in decision-making	160	100
No. of companies in which funds statements were tied in with changes in cash account	57	36
No. of companies in which funds statements were tied in with some budget	120	75
	Companies	Per Cent
BUDGETS USED:		
Completely tied in with all budgets used	25	21
TIED IN WITH:		
Cash budget	74	62
Financial budget	72	60
Capital budget	72	60
General budget	41	38

Seventy-five per cent of the companies that reported that they used the funds statement for making financial decisions tied the funds statements in with one or more of their budgets. These 120 companies also represent 61 per cent of all companies using the funds statement for any purpose whatsoever, and 92 per cent of all companies that use the funds statement in projected form. The thesis that the funds statement is an important tool for systematic planning is thus reinforced.

Company experience with reconciliations of funds statements and budgets seems not to vary greatly with the size of the company. However, those companies with total assets over $100 million have tied in the funds statement completely with all the budgets in the great majority of cases.

Financial Planning

The funds statement has been tied in preponderantly with the cash, financial, and capital budgets, and to a much lesser extent with the general budget. The extent

[4] This is substantiated by a report on budget practices, "What Good is A Budget," *Business Week*, November 15, 1952, pp. 32–33. See also, Dean, Joel, "*Managerial Economics*," Prentice-Hall, Inc., New York, 1951, p. 557.

to which use is made of funds analysis in capital budgeting emphasizes anew the close relationships between funds retained from earnings and depreciation, and capital financing.

The short-term planning period is also emphasized by the heavy use of funds analysis and cash budgets, the periods of funds statements projections previously noted, and the relatively large number of cases (36 per cent) in which funds statements were tied in with the changes in the cash account.[5]

The reconciliations necessary to integrate the funds statements with budgets offer a measure of control of funds sources and dispositions. This would be especially true if widespread use of matching actual with projected funds statements were to be adopted. As previously mentioned, many of the respondents disclosed systematic pursuance of this technique although the actual extent of this practice is indeterminate.

[5] "There is evidence to suggest that the cash position of the enterprise may have a decisive influence on the expenditures for innovations." Committee on Price Determination, "*Cost Behavior and Price Policy*," Nat. Bur. of Economic Research, New York, 1943, p. 165.

ANALYSIS OF FUNDS STATEMENTS SUBMITTED AS BEING USED IN INTERNAL REPORTS

Analysis of funds statements used as internal reports by the various companies is afforded by a review of 105 statements submitted by 83 companies. These were submitted in answer to requests for samples of internal funds statements and forms used to reconcile funds statements with budgets. Of the 105 statements submitted 85 were funds statements, one each per company except for two companies that submitted funds statements on both a cash basis and a working capital basis. No discernible pattern of response by size of company was noted. Each size group was adequately (50 per cent or more) represented.

Forms of Presentation

Table VI shows the favorite form of funds statement in use as an internal report to be the remainder type of the report-form. Fifty-six per cent of all funds statements submitted were of this type. Sixty-nine per cent of the funds statements were reported on a report-form basis since 13

TABLE VI

FORMS OF FUNDS STATEMENTS USED IN INTERNAL REPORTS TO MANAGEMENT*
(By Size of Company)

	Size Groups					*Total*	
	A	*B*	*C*	*D*	*E*	*No.*	*%*
(1) Balanced form (sources=applications)	3	1	9	9	4	26	31
(2) Report form, reconciling type (reconciling beginning "funds" balance with ending "funds")	2	1	6	1	1	11	13
(3) Report form, remainder type, (sources−applications =increase or decrease in funds)							
Analytical	1	0	0	0	1	2	2
Unreconciled	7	7	11	1	4	30	35
Reconciled (increase or decrease in funds from funds statement reconciled with beginning and ending funds balances on separate schedule)	5	0	5	5	2	16	19
Total remainder type	13	7	16	5	7	48	56
Total funds statements submitted	18	9	31	15	12	85	100

* Compare with Table VII in previous article. See Footnote 1 for reference. See Footnote 2 for company size groups.

TABLE VII

EXTENT OF DETAIL IN FUNDS STATEMENTS USED IN REPORTS TO MANAGEMENT
(By Size of Companies)

No. of Items	*Companies*					*Total*	
	A	*B*	*C*	*D*	*E*	*No.*	*Per Cent*
0– 4 items	0	0	0	0	1	1	1
5– 9 items	4	2	9	2	1	18	21
10–19 items	9	5	19	11	6	50	59
20–29 items	4	1	1	2	4	12	14
30 and over 30 items	1	1	2	0	0	4	5
Total	18	9	31	15	12	85	100

per cent were of the reconciling type of report form. Only a small number of funds statements were used in any analytical form—less than 2 per cent. This is particularly significant since this sample covers all internal uses of funds statements whether used as reporting devices or as planning devices. The need to keep the funds statement simple is also illustrated by the remark frequently submitted under "comments" in the questionnaire, that "some of our directors don't understand the funds statement."

The balanced form of funds statement, the first form developed, was used in only 31 per cent of the cases submitted. Heaviest use of this balanced form occurred in corporations with total assets under $50 million. Fifty per cent of this use is concentrated in corporations having total assets of less than $10 million. Apparently this form has been largely abandoned by the large companies.

Extent of Detail in Funds Statements

The need for simplicity is revealed by analysis of the detailing of items in funds statements submitted. There was a detailed analysis of the funds statement in only one sample. The number of items reported in managerial funds statements, however, was more than the number of items in funds statements to stockholders. The average number of items reported was only between 10–19 items. The detail is shown in Table VII.

Only 19 per cent of the companies reported more than 20 items per funds statement. Only 5 per cent reported more than 30 items. On the other hand, 22 per cent of the companies reported less than 10 items, or an average of less than five sources and five dispositions. The great bulk of the companies, about 60 per cent, reported from 10 to 20 items. These facts, together with the complete lack of analytical funds statements, show that the summary-type funds statement is firmly entrenched in practice.

The length of the funds statement does not seem to vary greatly with the size of the concern. Apparently, major classifications of funds sources and dispositions have been important, and such major classifications alone may be enough to accomplish the desired ends.

Concepts of Funds

The concept of funds used, as determined from the internal funds statements submitted seemed to vary little from that used in general. This analysis is shown in Table VIII.

The concepts reported here are derived from careful analysis of the statements submitted. An upward bias probably was introduced for the working capital concept since this concept was considered to be

TABLE VIII

CONCEPTS OF FUNDS USED IN INTERNAL REPORTS TO MANAGEMENT
(By Size of Company)

Funds Concepts:	*Companies*					*Internal Reports*		*(Stated as General Concepts)**
	A	*B*	*C*	*D*	*E*	*No.*	*%*	
Cash	5	2	6	4	2	19	22	26.5
Cash & U.S. Sec.	4	1	0	0	0	5	6	2.5
	9	3	6	4	2	24	28	29.0
Working Capital	7	6	24	10	10	57	67	50.5
Net Quick Assets	0	0	1	0	0	1	1	7.5
All Items	2	0	0	1	0	3	4	2.0
	18	9	31	15	12	85	100	
Current Assets								1.5
Miscellaneous								9.5
								100.0

* Compare with Table V of article mentioned in footnote 1.

used whenever the funds statement was supported by a working capital schedule. The balanced-type funds statement tends to obscure the concept of funds used. With the possible exception of the net quick assets concept (working capital less inventory), and the working capital bias previously noted, there seems to be little difference in conceptual outlook between general purpose funds statements and those for internal uses only.

Depreciation and Non-funds Items

The handling of depreciation and allied non-funds items on internal funds statements is shown in Table IX.

Table IX shows data for all companies only, since there appears to be little difference in results among different sized groups. There is a strong correlation between the handling of the depreciation item in internal reports, and the handling of the item in reports to stockholders.

Special Items

Certain items not handled as individual items in funds statements to stockholders were handled separately in the internal reports. Chief among these were taxes, 31 per cent; inventories 28 per cent; short-term receivables, 28 per cent; and short-term payables, 31 per cent. In addition, pension payments were frequently noted. The inventory and short-term items, of course, are shown separately if a cash concept of funds is followed. The pension payments may be shown separately under any concept of funds.

Taxes are usually not shown separately, as they normally are a component part of reported net profits. Since taxes represent such a heavy outlay of funds, it is not surprising that more emphasis is given to this item in the internal funds statement. Quite frequently an adjustment of reported net profits was made in order to show the taxes separately.

Funds Statement Periods

An analysis of the 85 company reports submitted as examples of internal funds statements shows that these were prepared essentially for short periods. Table X, prepared for both historical and projected

TABLE IX

HANDLING OF DEPRECIATION AND OTHER NON-FUNDS ITEMS IN THE FUNDS STATEMENTS

	Reported to Management		*Reported to Stockholders**
	No.	*Per Cent*	
Depreciation shown as a separate item but added to profits (reconciliation)	34	40	36
Funds reported from profits before depreciation, etc., depreciation amount given short or paranthetically	4	5	11
Depreciation handled through "Expenditures net of depreciation changes" (Depreciation amount stated)	0	0	4
Depreciation shown as a separate source; no reconciliation to net profits offered	47	55	50
	85	100	100

* See Table VIII in previous article.

funds statements, indicates preponderant use of periods of less than one year. Capital expenditure budgets and estimated profit and loss statements on a funds basis, were the only ones used chiefly in the long run. Since few of these were submitted, there may be some bias towards the shorter-term statements. This bias is not considered significant.

TABLE X

LENGTH OF FISCAL PERIODS OF FUNDS STATEMENTS ANALYZED—INTERNAL USES

	No.	*Per Cent*
Year-to-date by months	23	27
Monthly comparative	10	12
Monthly for a quarter	3	4
Quarterly for a year	14	16
Semi-annually	6	7
Annually	22	26
1–5 years	1	1
Not stated	6	7
	85	100

If this table is compared with funds statements in reports to stockholders, significant differences are noted.[6] First, funds statements for periods of less than one year were found much more frequently here than in reports to stockholders. Annual reports, of course, are predominantly used for stockholders reports. Secondly, the use of comparative funds statements was much more pronounced. Thirdly, comparisons of actual with budgeted; and "running" funds statement of actual for past periods, comparative for the immediately past and present period, and budgeted for future periods were fairly common. These are expected in operational statements but would be of less use to stockholders.

Titles of Funds Statements

Table XI shows the titles used for funds statements prepared for managerial use. No attempt has been made to segregate historical from projected statements, and we have eliminated as far as possible qualifying terms such as "projected" or "budgeted" unless they were an integral part of the title.

The main differences in titles of funds statements prepared for internal use and those prepared for stockholders' reports were in the greater use of "funds" and "cash" in the titles of the internal reports, and a decrease in use of the term "working capital." Thus, "funds" was used in 59 per cent of the cases in the internal reports, as compared with 46 per cent in the stockholders' reports. "Cash" was used in 13 per cent of the internal reports, and only 7 per cent of the stockholders' reports. "Working capital" was used in 29 per cent

[6] Anton, *op. cit.*

TABLE XI

TITLES OF FUNDS STATEMENTS USED IN INTERNAL REPORTS TO MANAGEMENT

	No.		*Per Cent*
Titles Including:			
"Application of Funds" in the title	24		28
"Sources and Application of Funds" in title	13		15
"Sources and Disposition of Funds" in the title	6		7
"Sources and Uses of Funds" in the title	2		2
"Funds Provided and Applied" in the title	3		4
"Funds" in the title	2		2
Denoting Source & Application of Funds		50	59
Flow Sheet		1	1
Titles including:			
"Summary of Financial Operations"	2		2
"Changes in Financial Position"	3		4
Denoting "financial" aspects		5	6
No title—textual remarks mentioning "working capital"	1		1
Title including "Working Capital"	13		15
Titles including "Net Current Assets"	2		2
Denoting working capital sources and dispositions		16	19
Titles including:			
"Source and Use of Cash Funds"	4		5
"Forecast of Cash Position"	6		7
"Cash Control"	1		1
Denoting cash sources and dispositions		11	13
Titles including "Disposition of Earnings"		2	2
Total		85	100

of the stockholders' reports, but only 19 per cent of the internal reports included this term. The high percentage of "application of funds" titles may give an insight into the psychology of the statement as a reporting device—accounting for the *use* made of available funds.

CONCLUSIONS

The preceding analysis of funds statement practices of industrial corporations provides one salient conclusion: Funds statements are an important tool for managerial planning, control, and reporting. Sixty-eight per cent of the respondent companies use the funds statement, 97 per cent of these for internal reporting. Less than 20 per cent use the statement for reporting to stockholders. Since the funds statement has been adopted in most cases within the past ten years, a further increase in adoptions may be forthcoming. At any rate, the wide extent of usage as an internal report is dramatic. It emphasizes the need for continued research in this area of financial reporting.

BUDGETARY ACCOUNTING PROCEDURES AND ACCOUNTING FORMS FOR SMALL* COLLEGES AND UNIVERSITIES†

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INCREASED VOLUME of financial transactions and the added complexity of auxiliary enterprises incident to an educational institution in these days necessitate a system of budgetary control for planned income and expenditures. Successful management demands budgetary control even in our smallest colleges.

Not only have auxiliary activities been added to operations, but the volume has increased many per cent and now includes student activities and organizations, student union, intercollegiate athletics, bookstore, resident and dining halls, coffee shop, laundry, hospital, central stores, bakery, farm, meat shop, maintenance shops, veterans housing, printing, and publishing. These activities, together with current, endowment, loan, retirement, and plant funds, as well as operations for administration, instructional, and non-educational departments, make it imperative that the accounting system produce up-to-date, accurate and permanent records of all financial transactions for good budget control.

Mechanical accounting is essential in supplying the administration and various division heads with the necessary data for a greater degree of physical and budget control. We know that frequently faulty administrative and trustee decisions have been due to incomplete bookkeeping records. In recent years the mechanization of accounting in college business offices has progressed very rapidly. Old principles are being applied in new ways; many traditional forms have been altered; combined procedures and short cut operations have been effected. Accountants should be informed on modern accounting methods, form collators and multiple registers on accounting machines, distribution devices and many other technical features which are affecting the availability, cost and content of accounting records formerly prepared manually.

Twenty-one schools were asked to report on their accounting procedures, from which will be developed five areas of accounting procedure which give support to good budget control, together with a brief comment on observations made by the twenty-one reporting schools.[1]

These five areas for consideration are: purchase requisitions, and orders; voucher check register, ledger, and check procedure; employees' individual earnings record

* Enrollments of 2500 or less.

† This paper was presented before the Central Association of College and University Business Officers meeting held at Oklahoma A and M College, April 26, 1954.

[1] The institutions reporting were Beloit College, Wisconsin; Carleton College, Minnesota; DePauw University, Indiana; Drake University, Iowa; Grinnell College, Iowa; Hamline University, Minnesota; Illinois College, Illinois; Illinois State Normal University, Illinois; Kalamazoo College, Michigan; Knox College, Illinois; Macalester College, Minnesota; Marietta College, Ohio; Michigan State Normal, Michigan; Monmouth College, Illinois; Oberlin College, Ohio; Omaha University, Nebraska; Pomona College, California; St. Olaf College, Minnesota; South Dakota State, South Dakota; Union College, New York; and Yankton College, South Dakota.

and deductions; student charges and journal entries; budgetary accounting procedures and departmental reports.

ORGANIZING FOR BUDGETARY CONTROL

The factors which are essential in the development and operation of a plan of budgetary control within a college are (1) formulation of a financial plan, (2) applying the plan, and (3) checking the results. Before such a plan can be most effective, the lines of authority and responsibility in the college or university must be clearly defined; an organization plan, with definitely outlined duties for each of the executives from the president to the least important department head, is required, because budgetary control is based upon the proper division of the functions among departments and officials, and the setting forth of the responsibilities of each. An organizational chart should be prepared to show graphically the various departments and functions, the relationship between units and the duties to be performed by each of the division heads.

Purchase Requisitions and Orders

At Carleton College, requisitions for services and material to be filled from both our central stores and outside vendors are sent to the purchasing agent after being approved by the department head. Estimates or actual bid prices are obtained and entered on the requisition together with the account and fund numbers and the requisition is checked against the free balance. They are then sent to the treasurer's office for approval. Carleton has the carbon snap-out, four-part, pre-numbered requisition and purchase order forms. Procedures and explanations are provided on the requisition forms in such detail that step-by-step procedure is unnecessary. A copy of the requisition is provided for each department involved in the procedure and a copy of the requisition is used as a receiving ticket which becomes a supporting document to the purchase order and vendor's invoice. This procedure makes it unnecessary to secure the approval of the department head on the vendor's invoice, an important factor in speedy processing. However, two copies of the vendor's invoice are required, one copy to be retained by the requisitioning department. The four-part purchase order provides a copy for each department involved in the process. The purchase order provides for a price, and the approval of the vendor's invoice is based on the price shown on the purchase order.

In the nineteen reporting schools having machine bookkeeping, all used both the requisition and purchase forms. Eight use the snap-out type of form for the requisition and purchase order. Four of the schools have terms of 2% for ten days unless otherwise stated on invoice. A number left the terms blank to be filled in. Most of the schools had the long form type of purchase order. This past year Carleton has reduced the purchase order to $8\frac{1}{2}$ by $5\frac{1}{2}$, approximately the same size as the requisition form which allows us a saving in cost and gives better filing and reference efficiency.

Voucher Check Register, Ledger, and Check Procedure.

We use a four part snap-out voucher check. The invoices and supporting documents are stapled to the duplicate copy of the check. These copies are made up in different colors to represent different banks and to aid in the sorting as to banks. These copies of the voucher checks become the numerical vouchers which are the posting media for charges to the expense and balance sheet accounts. Both the duplicate copies and the quadruplicates listed by bank are posted daily. Most of the institutions reporting use the voucher snap-out form and about half are using the book-

keeping machine for writing expense checks.

It certainly is gratifying and reassuring that all of the schools, with the exception of two, require checks to be signed by only one individual in the office of the treasurer. This year Carleton College has eliminated the use of writing in the amount on checks with a mechanical protecting machine. The amount is typed in just once when the check is written. The elimination of this procedure has been an added timesaver.

Employees' Individual Earnings Record and Deductions

Present payroll procedures are complicated by numerous factors occasioned by irregular salary arrangements, various insurance programs, board, bookstore, rent, pension, social security, and withholding tax deductions. Getting the maze of lists, time slips, deductions, and withholding tax organized so that the payroll checks can be written calls for a carefully worked out procedure. With the exception of social security and withholding tax, the numerous other deductions have been reduced to an accounts receivable statement which greatly simplifies the preparation of the payroll check. This phase of the procedure can usually be accomplished when convenient during the month by the bookkeeper. The various deductions other than social security and withholding tax are kept on 3×5 card files and they can either be kept separately or the corners of the cards can be cut to reflect the different class deductions. Cards show the employee's name, kind of deduction, amount to be deducted, and when to be deducted. Changes and additions are made on the cards so that the amount to be deducted is always up-to-date. Sometime before payroll date, each box is listed and totaled. Tapes are labeled and forwarded to the Accounting Clerk. Pensions, annuities, and board are also handled on cards in the same manner. These cards, sorted by name, are posted to the Accounts Receivable Ledger. A customer's statement is prepared simultaneously with this posting.

In the reports from the various schools, the number of deductions varied from 5 up to 16. Code numbers were generally used for all deductions on the explanation portion of the payroll check. All except state institution payroll checks were written by a bookkeeping machine. In all but one or two, payroll checks carried one signature. On the individual employee's earning card most of the institutions carried fixed deductions at the top of the card and provided columnar space for 6 to 8 deductions.

Student Charges and Journal Entries

Student accounts are kept on a machine-posted ledger which accommodates entries for four years. The entire history of the financial arrangements with each student is, therefore, on one card instead of several. Carleton College uses a comprehensive fee; therefore the break-down of this fee and other charges is accomplished by batch sorting. By use of a double student wrap-sheet carbon statement over the ledger card, the charges and credits are made simultaneously on student statements and ledger cards. These are handed to the students at payment time at the opening of the semester. On these are shown their charges together with any credits made before the first semester; for the second semester, the second statement shows the credits and charges through the first semester. In addition to the ledger cards, at the present time we use a small student memo worksheet which allows space for scholarship grants, work grants, and a deferred payment plan. As our cash receipt, we use a four-part receipt form, size $4\times3\frac{1}{2}$ inches. Spaces are allowed to check whether men or women students, or faculty, and spaces are designated for application, admission, room, and student ac-

counts. A blank is provided for accounts other than the above and there is also a place for checking whether cash or check. The second copy is for office reference distribution, the third copy for posting and proper credit by the bookkeeper, and the fourth is post-bound and used as a bank journal.

The standard journal entries which are made each month adjust both student and other accounts and are made on a journal voucher, providing for detailed appropriation ledger entries on the back of the form. This feature facilitates posting on two bookkeeping machines at one itme. It also facilitates the preparation and posting of journal vouchers covering entries to the same account in different departments. The form has an explanation feature which permits unlike entries on the same voucher and at the same time furnishes complete explanation of each entry. The journal voucher with supporting documents is bound according to months with an Acco fastener. The method of handling student accounts particularly as to forms used among the reporting schools showed considerable variance.

Budgetary Accounting Procedures and Departmental Reports

The first step in developing a budget is the preparation of estimates for the various items of both income and expense which will be incorporated in the complete budget. These are called for in March on special forms that are to be in the Business Office by the first week in April. The instructional departmental budgets must have the approval of the Dean of the College. Then the preliminary and tentative budget is approved by the Board of Trustees at their June meeting. We operate on this preliminary approved budget until October, when the final revised budget is approved by the Board of Trustees. The annual budget at Carleton College is built up by accounts. Some appropriations, such as salaries, are expended on a monthly basis and so are charged evenly throughout the fiscal year, whereas others are substantially used up early in the year. Unencumbered balances must be judged in the light of the portion of the appropriation customarily expended during the period under review. For example, annual appropriations for science laboratory supplies and repair and replacement of equipment would likely be used up early in the school year, and a low free-balance in the appropriation account on December 31 is to be expected. Departmental salaries are expended during the academic year and the free balance on December 31 will be about three-fifths of the annual appropriation. Administrative salaries are expended evenly throughout the fiscal year and these appropriation accounts would be one-half used up by December 31. It is helpful if you are able to have each appropriation account under the annual budget allocated to the four quarters of the fiscal year on the basis on which it will be expended.

This allocation should be made by the department head who prepares the annual budget, perhaps with some guidance from the Business Office. The allocation of the annual budget to fiscal quarters may in some cases be arrived at by a percentage break-down, but to be useful to management, the final form must be in dollars. This allocation permits a presentation of the budget in terms of estimated unencumbered balances, such as those at the end of each fiscal quarter, and can be compared to the actual unencumbered balances shown by the monthly reports on the quarterly basis.

Carleton's appropriation ledger is a combination expense and budget control ledger. Its design permits full use of the automatic features of the bookkeeping machine, and means that fewer man-hours

are required for posting. We are using the Monticello appropriation ledger jackets with insert sheets, which give each department detailed reports automatically as a by-product of the ledger postings. Quarterly reports of expenditures, encumbrances, and free balances are made on a printed report form which is prepared on the bookkeeping machine. In addition to the balances of each account, the bookkeeping machine will furnish department totals automatically. The form provides a remarks column which is helpful in explaining or calling attention to unusual circumstances. The report can cover the entire college budget by merely recapping the departmental totals. The proof sheets which are prepared automatically as a by-product of these reports, are cut into pages $8\frac{1}{2} \times 11$ in size and stapled into a pamphlet form for use as a report for the Business Office. From this can be spotted over-expended budgets without examining each ledger card.

The budget is broken down into the following categories and account classifications:

budget is, at least with reference to the standards established by the budget, a check on the efficiency of any department.

Actual operating results should be compared with the budget estimates at frequent intervals so that differences may be determined and analyzed in time for corrective measures to be effected. If a comparison of achievements with the budget discloses unsatisfactory results, steps may be taken to enforce the budget by bringing pressure to bear upon individuals responsible for the unsatisfactory results, or by correcting conditions which contributed to the unsatisfactory results. Comparisons of the budget and the accomplished operations may, however, indicate the advisability of modifying the budget rather than attempting to enforce it. If the comparisons indicate that, in preparation of the budget, there was some failure to give consideration to all the controlling conditions, or if conditions are found to have changed materially, the remedy lies in the correction of the budget. The budget should reflect rather than dictate the policies of the management. This is important

Administrative Offices Instruction Library Organized Research Auxiliary Non-Educational	Salaries, Student Work, Supplies, Repair and Replacement of Equipment, Travel, Other Expense (broken down to Telephone, Laundry, Publications, etc.) and Capital Additions.
Buildings Grounds	Service Expense, Repair and Replacement (broken down to Equipment, Buildings, and Grounds), Reserve for Major Replacements, Heat, Light, Power, Water, Insurance, and Capital Additions.
Income Producing Service Properties—such as, dormitories, dining halls, bookstore, hospital, power plant, faculty club, etc.	Student Work, Salaries, Supplies and Services, Repair and Replacement (broken down to Equipment and Building), Heat, Light, Power, Gas, Water, Insurance, Telephone, Laundry, Interest, Reserves for Replacement for Equipment and Building, General Administration, Capital Additions, and the cost of food, broken down into types, and a distribution of the cost of Food Service added for the Dining Halls.

The comparison of results finally obtained in these budget forecasts is a valuable means of measuring the effectiveness of actual operations. A comparison of the actual distribution costs for any period with the anticipated cost shown by a

in gaining the confidence of the college department heads, so that in its preparation there is a realistic budget and not one that is padded in order to give department heads flexibility in their operations.

Seven of the schools surveyed encumber

purchase orders. However, most of them are state schools. The balance of the schools encumbering their purchases have enrollments of approximately 2,000. There is a feeling that for small or medium size institutions, the cost and problems of control are unwarranted. The details posted to the general ledger control cards should be only those details required for good control and reference. It is true that sound record-keeping does not require that all kinds of requested information be available immediately or, in some cases, that it be available at all. However, two years ago we followed the experts' advice and eliminated the detailed explanation in our ledger accounts and, because of sad experience, we have gone back to furnishing this information which our faculty members are constantly requesting. The form and detail with which records are kept is, of course, a matter to be determined by the needs of the administration in the light of the cost in keeping such records. A number of schools use coding for their classified expense accounts.

CONCLUSIONS

The use of a budget focuses the attention of the officers of the administration on the whole organization and attempts to eliminate unbalanced or inefficient operations and promote coordinated action in all departments. A properly prepared budget accomplishes five things; fixes a definite goal with respect to earnings and financial condition; establishes a yardstick for measuring results; provides a means of comparing estimates with actual accomplishments, and thereby gives the management a means of effective analysis; provides a means of coordinating the activities of the various departments; develops better practices of internal audit and efficiency in operating income and costs by department heads and personnel. Offsetting the above advantages, there are certain disadvantages. One, the budget is an estimate; two, it takes considerable time in its preparation and application before results and benefits are secured; and three, it increases expense because its preparation requires research, study, and extra work, both on the part of the executives and employees.

In summary, the budget routine includes the following steps:

1. Preparation of preliminary budgets of income and expenditures for each department of the college.
2. Review, revision, and acceptance of the individual budgets by the budget committee.
3. Consolidation of the departmental budgets into the comprehensive budget for the entire college.
4. Review, revision, and approval of the preliminary college budget in June and of the final budget in October by the Board of Trustees.
5. Accumulation of actual results and preparation of reports comparing budgeted and actual amounts, and the explanation of variations from estimates.

THE RESPONSIBILITY OF THE INTERNAL AUDITOR FOR PROCEDURES*

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ON July 15, 1947, the Board of Directors of the Institute of Internal Auditors issued a statement known as "Responsibilities of the Internal Auditor." Under the subtitle "Nature of Internal Auditing" is the following quotation: "Internal Auditing is the independent appraisal activity within an organization for the review of the accounting, financial, and other operations as a basis for protective and constructive service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters, but it may also properly deal with matters of an operating nature."

The term "independence" in the above statement depends on two major points. First, the head of the internal auditing department should be responsible to an officer of sufficient rank as will assure proper review of the findings or recommendations and initiate any action indicated. The range and value of the services which management can expect from an internal auditor will be determined largely by the support given him by management and his position in the organization. The report of the 1950–51 survey of the Committee on Internal Auditing Principles and Practices indicates that 90 per cent of the chief internal auditors report to officers having titles of Controller, Treasurer, Vice-President, President, or Chairman of the Board. Further, the survey reports that 211 out of 270 companies permit the auditor to examine all records and correspondence, and may enter any office or property of the employer to carry out his work.

The second point necessary for independence as brought out in the 1947 Statement is as follows:

"Internal Auditing should not include responsibilities for procedures which are essentially a part of the regular operations of a complete and adequate system or of a properly organized operating department." The 1950–51 survey showed that 187 companies have separate systems and procedures organizations. The other one-third of the companies possibly are not large enough to divide these duties.

The 1947 statement indicates that the total objective of the internal auditor has two phases:

1. The protection of the interests of the organization, including the pointing out of existing deficiencies to provide a basis for appropriate corrective action. The attainment of this objective involves such activities of the internal auditor as:
   a. Ascertaining the degree of reliability of accounting and statistical data developed within the organization.
   b. Ascertaining the extent to which company assets are properly accounted for and safeguarded from losses of all kinds.
   c. Ascertaining the extent of compliance with established policies, plans, and procedures.
2. The furtherance of the interests of the organization, including the recommendation of changes for the improvement of the various phases of the operations. The attainment of this objective involves such activities as:
   a. Reviewing and appraising the policies and plans of the organization in the light of the related data and other evidence.
   b. Reviewing and appraising internal rec-

* This paper was presented at the Sixth Annual Meeting of the Southeastern Group, University of Florida, May 7, 1954.

ords and procedures of the organization in terms of adequacy and effectiveness.

c. Reviewing and appraising performance under the policies, plans, and procedures.

The internal auditor is usually guided by an audit program and specific check lists covering each phase of his audit. He must apply all of his ingenuity, imagination, and common sense to make proper appraisals and present constructive suggestions.

If the internal auditor is to do a satisfactory job in the matter of auditing procedures, he is presumed to know as much about the design and installation of procedures as do the systems and procedures experts. This calls for proper relations with the latter. One method which has been successful is to regard procedure and performance as integral parts of the whole program. If the auditor proceeds on the theory that procedure and performance are so closely related that an appraisal of performance takes into account its purpose and method of achievement, he will resolve most of the problems of this phase of his work.

How may an inadequate procedure be recognized? The auditor must understand the procedure's purpose, its nature, and the results to be expected, including the following:

1. The end or ends to be accomplished—the purpose of management to be fulfilled.
2. The system or procedure, usually thought of as the "who, what, where, when, and why."
3. The unit of measure for evaluation of performance and results.

From an appraisal-of-performance point of view, it would appear to be impossible to make an evaluation, including the end product or result, without including within the scope of examination, the objective and the procedure under items one and two above. Often an audit examination, proceeding from one deficiency clue to the next, leads to the plan or policy as the seat of the shortcoming. Performance and results may appear on the surface to be lacking because of procedure deficiency, when the real facts are that the difficulty is one of policy defect.

Inasmuch as the procedure is derived from policy, and is the reason for the procedure, the policy should be the first item for audit attention.

In connection with policy, these questions may be raised:

1. What was the original purpose?
2. What factors, with regard to fulfillment of purpose, were considered as the basis for its adoption?
3. What changes have taken place in these factors which might be causes for review with an idea of revision or discontinuance?

Factors to be considered in evaluating and reviewing policy matters are: general economic conditions, product changes, change in customer type, growth of the company, company organization structure. Personnel changes often have an important bearing on policy and procedure. In a large concern, it may be necessary to continue certain practices in the interest of mutual harmony and unity within the organization. The auditor should determine whether the employees are qualified to perform the assigned task. This relates directly to performance. Unsatisfactory results may be laid to lack of proper qualifications, when in fact the cause may be policy defect or poor procedure.

Attention must be given to the problem of clerical mechanics, with some of the following questions in mind:

1. What are the desired results?
2. Can more than one procedure be used?
3. What are the comparative costs of alternative methods?

Procedural details to be considered should include the following:

1. Working conditions—ventilation, light, floor space, temperature control.

2. Form design—is all the required information necessary? Do all copies have a useful purpose?
3. Methods of Performance—mechanical or manual. Often more details are required than are necessary. Possibly mechanical equipment is not the proper type. Can several different steps be combined and punched cards used instead? Are the various procedures in logical order?

The internal auditor can make an important contribution to the use of efficient procedures; to do so will require the following on his part:

1. The acquisition of a comprehensive understanding of the applicable management objective known as the policy plan.
2. An understanding or familiarity with the various types of tools which can be utilized in the fulfillment of the management objective. This refers to required employee qualifications, the various manual or mechanical means together with related supplies which may be used for this purpose.
3. The development of the ability to prepare reports containing recommendations or suggestions which would be readily accepted for further study and action.

FEDERAL INCOME TAX PRACTICE IN THE UNIFORM CERTIFIED PUBLIC ACCOUNTANT EXAMINATION

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HIGH STANDARDS in professional accounting are the result of the efforts of men with vision working together towards an objective. Today, thousands of accountants are well-established professional men demanding and receiving the respect of the people in their community. Standards have been high; competence has been the rule, not the exception. The infant profession of accountancy is coming into its own.

THE CPA EXAMINATION

The uniform CPA examination has had a major role in establishing and maintaining today's high standards. The purpose of the examination is to determine the technical qualifications of young men and women to enter the field of public accounting. If the uniform examination is analyzed through the years, the development of a dynamic profession will unfold through the evaluation of the technical information required of candidates. In discussing the uniform examination Mr. J. William Hope stated,

> "It follows that a uniform examination, adopted by all state boards, becomes the hall-mark of the profession. It measures the competency of an individual to practice public accounting as a CPA, and meeting its requirements marks the successful candidate with a stamp of approval for service to the public."[1]

The material included in the uniform examination must be carefully selected to evaluate properly the qualifications of those desiring to enter the profession of public accounting. Until comparatively recent years the subject of Federal income taxes was of little importance in the uniform examination. In fact, the subject was unknown when the first certified public accountants were examined. Even after taxing of income was declared constitutional in 1913, the Federal income tax laws were relatively unimportant to the practice of accountancy. Starting in the early 1940's and continuing to the present time, the subject has been increasingly important. The tax laws were increased in complexity and the rates were so high that income tax considerations have become foremost among business and individual problems. The relative importance of Federal income tax practice as compared with other areas of work performed by the certified public accountant makes it clear that a young man entering the profession must be competent in tax matters. It is the purpose of this article to suggest that another guide post has been sighted, and that the uniform CPA examination must be expanded to make adequate provision for the subject of federal income tax practice.

ALL PRACTICING CPA'S RENDER FEDERAL TAX SERVICES

There are many interesting relationships connected with the rapid expansion of accountancy as a profession. One of the more interesting is to note that the expansion of the profession occurred in the period when Federal income taxes were influencing an increasing number of busi-

[1] J. William Hope, "The Uniform CPA Examination." THE ACCOUNTING REVIEW, Vol. 24, April, 1949, p. 123.

ness decisions and claiming a substantial portion of business profit. Mr. Robert E. Witschel, in commenting on four factors which have brought about the rapid growth of the profession and which assure its continuance, stated,

"First, the growing complexity of tax laws is causing not only managers and owners of small businesses, but also many individuals as well, to realize their need for competent advice. Now every professional man, every farmer, every businessman, and man employer is a potential user of the services of the certified public accountant."[2]

There can be little doubt that the amount of tax work performed for clients is substantial in relation to other services in the average public accounting practice. On the basis of a questionnaire used for the CPA Handbook, it was determined that when continuous service was performed for a client, the percentage of chargeable staff time billed to clients for income tax work was as follows:[3]

Size of Firm	*Percentage*
1–15 persons (small)	29.0
16–35 persons (medium)	25.0
Over 35 persons (large)	19.5

Tax knowledge of the practitioner is utilized in any accounting work that is undertaken. All previous and contemplated transactions have a tax ramification. In discussing the knowledge needed by the CPA, Mr. I. H. Krekstein stated,

"Primarily, the practicing CPA should have a comprehensive knowledge of Federal income and excess profits taxes and income taxes imposed by the states and political subdivisions in which he practices. He also must have a knowledge of Federal estate and gift taxes, and the inheritance taxes in the state in which he practices. In addition he should have at least a working knowledge of all other taxes imposed upon the corporations, trusts, partnerships, and individuals he represents. But most important of all, the CPA should be able to recognize the tax implications of his clients' financial transactions so that possible adverse consequences may be avoided."[4]

The extent that Federal income tax practice is dominating professional thought is evidenced by the actions taken by the American Institute of Accountants. An extensive Tax Information Program has been carried on through the public relations department. The Institute's career film, "Accounting—The Language of Business," is effective in portraying the income tax portion of a CPA's practice. One entire issue of the Journal of Accountancy was devoted to the 1954 Income tax revision. There can be no mistake—income tax work is an important phase of the practice of the certified public accountant in 1954.

REASONABLE COMPETENCE AS ADEQUATE PROTECTION TO THE PUBLIC

The CPA is a qualified tax practitioner to the public, and no distinction is made between the tax specialist and the general practitioner. Professionally, this is probably an ideal situation; however, as in the case of accountants and attorneys alike, it could have its disadvantages if all practitioners were not qualified in income tax matters or were not aware of their own limitations and responsibilities. There is a necessity for qualified income tax specialists, as the tax laws are not static. Complete competence in tax matters is a full-time job. This, however, does not remove the urgency for competence among general practitioners. In discussing the dangers of incompetence in tax practice, Mr. Krekstein states,

"The specialist is better able to analyze a complicated tax problem and properly advise the taxpayer. He also is better able to distinguish between accounting and legal questions. On the

[2] Robert E. Witschel, *Building and Keeping a Clientele*, "CPA Handbook," Volume I, American Institute of Accountants, 1952, Chapter 2, p. 1.
[3] *Ibid.*, p. 27.

[4] I. H. Krekstein, *Tax Practice*, "CPA Handbook," Volume II, American Institute of Accountants, 1953, Chapter 21, p. 1.

other hand, the general practitioner who does not specialize in taxes and does not have the time to keep currently informed on tax matters may be less qualified to pass judgment on his own competence. Unless he can distinguish between the tax matter that he is qualified to handle and the one that he is not, he may endanger the successful outcome of a case or advise the client in a manner that will result in adverse consequences."[5]

If all young men entering the profession are to be adequately qualified in tax matters, they should be trained to keep abreast of current changes in tax practice as a part of normal professional development. As a matter of fact, the basic tax practice does not ordinarily change as much as many persons would have us believe, and if once qualified and accustomed to using tax services, the accountant should have no difficulty with tax revisions.

In measuring the public good which the accountant's services offer, we should consider the dependency of the public upon the accountant for tax advice. Mr. Mark E. Richardson states,

"A recent general determination made in one metropolitan area indicated that more than 80 per cent of the returns filed by other than taxpayers themselves were prepared by accountants and that more than 75 per cent of tax controversies were handled by accountants. While the tabulation was not broad enough to be dependable, it seems to be supported by the day-to-day experience of all tax practitioners."[6]

STANDARDS IN INCOME TAX WORK MUST BE HIGH

The accountant versus the lawyer in Federal and State income tax matters has always been a subject of considerable dispute. At a joint conference a statement of principles relating to practice in the field of Federal income taxation was agreed upon by members of both professions. A portion of this statement is as follows:

"It is in the best public interest that services and assistance in Federal income tax matters be rendered by lawyers and certified public accountants who are trained in their fields by education and experience, and for whose admission to professional standing there are requirements as to education, citizenship and high moral character. They are required to pass written examinations and are subject to rules of professional ethics, such as those of the American Bar Association and American Institute of Accountants, which set a high standard of professional practice and conduct, including prohibition of advertising and solicitation."[7]

It is in the best interest of the profession of accountancy that the uniform CPA examination eliminate any would-be CPA without adequate knowledge of Federal income tax practice. There can be no effective argument against the accountant's role in income tax service if there is always competence and a high standard of practice. Young men entering the field of accountancy, having passed a thorough examination in Federal Income Tax Practice, would be extremely well qualified to practice within the provisions of the statement quoted above. Competence in Federal income tax matters would be even easier to establish than at the present time, and as years pass standards could go only upward.

PREVIOUS CPA EXAMINATIONS

In recent years the subject of Federal income taxes has been included in at least two questions on each uniform examination. There has been at least one question in the Accounting Practice section and an additional question in the Auditing or Theory of Accounts section. A summary of the questions that have appeared in

[5] *Ibid.*, p. 42.

[6] Mark F. Richardson, "The Accountant's Position in the Field of Taxation," *The Journal of Accountancy*, The American Institute of Accountancy, August, 1954, p. 169.

[7] Statement of Principles Relating to Practice in the Field of Federal Income Taxation, Promulgated by the National Conference of Lawyers and Certified Public Accountants.

the Accounting Practice section is as follows:

Examination	*Points*	*Type of Examination*
May 1950	10	20 multiple choice questions
Nov. 1950	10	7 multiple choice questions and 6 questions requiring amounts be given
May 1951	10	10 True-False questions and 22 multiple choice questions
Nov. 1951	15	23 True-False questions and 22 multiple choice questions.
	One of 3 parts totaling 12½	Statement of rule on stock rights and computation
May 1952	15	24 True-False questions, 4 multiple choice questions and 5 questions requiring that two amounts be given
Nov. 1952	20	Preparation of Form 1040 (U. S. Individual)
May 1953	20	Preparation of Form 1065 (U. S. Partnership)
Nov. 1953	12	24 True-False questions
May 1954	20 to 30 minutes of 4½ hours	Computation of discrepancy in net income
	40 to 60 minutes of 4½ hours	20 True-False questions, 9 multiple choice questions, and 6 short answer questions

Questions that have appeared in the Auditing and Theory of Accounts sections are as follows:

Examination	*Section*	*Points*	*Type of Examination*
May 1950	Auditing	15	Computation of corporate net income and Schedule M.
Nov. 1950	Auditing	10	Computation of amounts to be showing on individual return arising out of a partnership interest.
May 1951	Auditing	12	Computation of amounts to be reported in Schedule I (Partners' share of income and credits).
	Theory	One of three parts totalling 12½ (Optional)	Statement of rules.
Nov. 1951	Theory	12½ (Optional)	Memorandum on problems involved in accruing income and excess profit tax.
May 1952	Theory	One of three parts totalling 15	Explanation of installment basis.
Nov. 1952	Theory	15 (Optional)	Excess profits tax
May 1953	Theory	12½ (Optional)	Adequacy of provision for federal income tax and returns to file.
Nov. 1953	Theory	One of three parts totalling 20 (Optional)	Trade of asset.
	Theory	12 (Optional)	Changes in accounting methods.
May 1954	Theory	One of three parts requiring 30–37 min. (Optional)	Carry-back provision.

In analyzing the examination questions there are some observations that can be made:

1. *Objective type questions have been used frequently*

They were used in seven of the nine Accounting Practice sections. Practitioners, as well as teachers of income taxes, are aware of a fundamental difference in testing income tax knowledge and in testing other subjects. In testing income tax knowledge, there is a great difference between knowing the rules and reflecting rules properly on a return. To illustrate: It is relatively simple to learn and recite the rule that contributions of a corporation are limited to 5 per cent of net income before deducting contributions, that contributions of an individual are limited to 20 per cent of adjusted gross income, or that the alternative tax is the smaller tax on a joint return if net income less

exemptions exceeds a certain amount. In the preparation of an actual return, however, it is first necessary to know the rule, then it is necessary to recognize the fact that the rule applies to the return being prepared, and, last, it is necessary to know how to reflect the rule on the return. In short, testing of practical income tax knowledge by the preparation of an actual return is a better measure of tax competence than is testing with objective type questions. While objective type questions serve a purpose, they should not be the exclusive method in any one examination. The preparation of actual returns required in the November, 1952 and May, 1953 examinations was a step in the right direction.

2. *During 1950 and May, 1951 a question on income taxes was required in Auditing*

Auditing is an important subject in the CPA examination, as it constitutes a large portion of public accounting work. There are so many audit techniques and procedures to examine that there is little room in this examination for the subject of income taxes. It is true that the auditor should know income taxes, just as he should know process cost accounting and commercial law. However, it should not be a material factor in evaluating proficiency in Auditing. The fact that income tax questions have not appeared in the Auditing section since May, 1951 is also a step in the right direction.

3. *From May, 1951 through May, 1954 examination, an optional question on income taxes has been included in the Theory of Accounts section*

Good accounting theory and income tax regulations are not always consistent, and therefore provide an excellent basis for a theory discussion. In some of the examinations, however, the questions were straight income tax questions. Again, it doesn't seem that income taxes should be a material factor in obtaining a passing score in Theory of Accounts. The fact that questions are optional does not change the necessity for limiting the inclusion of income tax material. The only theory involved in some income tax regulations can be traced back to a legislative compromise or a move to lose fewer votes to a pressure group.

4. *There has been a relatively narrow coverage of technical tax material*

With the present examination structure, the coverage of technical tax material would be limited, because of the necessity of testing in the areas that the section involved was intended to evaluate. For every income tax question or problem included, some other question or problem must be omitted. One advantage of the objective type question in such a situation is that it covers more tax points in a short period of time. It isn't possible within present examination limitations definitely to determine proficiency in even several of the broad areas, such as individual, partnership, corporation, and fiduciary returns. Also, it is difficult to test for an adequate knowledge of supporting data required for businesses, farms, capital gains and losses, and the many other tax questions with which the CPA should be familiar.

CONCLUSIONS

Income tax practice is an integral part of the profession of accountancy. Competence in income tax practice is essential if accountants are to lead the way in tax service to the public. High standards within the profession can be maintained and bettered if all young men entering the profession possess exceptionally high technical qualifications in income tax matters. If the certified public accountant is to

provide the necessary leadership in the field of Federal income taxes, the expansion of the uniform CPA examination to make adequate provision for Federal Income Tax Practice is the first logical move to raise standards even higher than they are today.

RECOMMENDATIONS

The uniform CPA examination should be expanded to make adequate provision for testing knowledge of Federal Income Tax Practice. A four-hour section devoted exclusively to Federal Income Tax Practice is not out of line with the importance of the subject. Such an examination is necessary for the protection of the public by providing practitioners with proper training in Federal Income tax matters.

An examination in Federal Income Tax Practice should be realistic. Nothing can be gained by having candidates memorize tax rates or detail tax rules. At least a portion of the examination could be given under field conditions—that is to say, the candidate should be able to use a standard one-volume Federal Income Tax Service in answering questions or preparing returns. The ability to use standard tax services is essential to any income tax practitioner.

Boards of Accountancy in states having income tax laws should be encouraged to require candidates to pass a one- or two-hour examination on state income taxes, in addition to the uniform examination.

THE TREATMENT OF "FOOTNOTE" LIABILITIES

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Current inadequacies in financial reporting center primarily around failure to disclose the aggregate effects of both price-level changes and "footnote" liabilities.[1] Accounting literature has treated problems arising from price-level changes extensively in recent years, but has neglected those arising from the incomplete recognition of liabilities. It is with the idea of redressing this disproportionate emphasis that the following comments pertaining to "footnote" liabilities are offered.

In treating this subject, attention is directed principally at pension obligations, lease agreements, and construction commitments. Conclusions drawn with respect to these items clearly apply to other imperfectly disclosed liabilities. The essential premise is that, although footnote recognition is better than none at all, it is insufficient.

In a sense, the full disclosure of liabilities is more definitely the accountant's responsibility than is the adjustment for price-level changes. It may be that price stabilization policies—clearly beyond the scope of accounting—are the only satisfactory solution to the problem of price-level changes. It may also be that some readers of financial statements prefer money, as opposed to deflated or real, values.

Neither of these points applies to full disclosure. The effective execution of this function is perhaps the most important task assigned to the accounting profession. With the possible exception of a few insiders, users of financial statements unanimously favor full disclosure of liabilities (and assets as well).[2] The myth that full disclosure may impair a company's competitive position has been exploded countless times in the past two decades. Of substantially more importance to efficient operations than the danger of revealing competitive secrets is the need for data against which to measure performance.

For immaterial items, the consensus appears to be that application of the full disclosure and uniform treatment requirements is discretionary. The American Institute of Accountants states that:[3]

> ". . . its opinions will have application only to items material and significant in the relative circumstances. It considers that items of little or no consequence may be dealt with as expediency may suggest. However, freedom to deal expediently with immaterial items *should not extend to a group of items whose cumulative effect in any one financial statement may be material and significant.*"

Since few individual items may appear material if the itemization is sufficiently detailed, the underlined portion is crucial.

It is unfortunate that the cumulative effects of immaterial items have not received more emphasis. The establishment of specific standards for the treatment of individual items and the frequent reference to materiality by the American Institute

[1] "Footnote" liabilities comprise lease agreements, pension obligations, construction commitments, and a wide range of other liabilities which, if disclosed at all, generally appear in footnotes to published financial statements.

[2] The concept "full disclosure," as employed herein, does not necessarily imply "itemized breakdown." Excessive detail may, at times, be as misleading as outright omission.

[3] American Institute of Accountants, "Restatement and Revision of Accounting Research Bulletins," *Accounting Research Bulletin, Number 43*, p. 9. (Underlining is added for emphasis.)

draw attention away from the need for full disclosure in the aggregate sense. In the writer's opinion, the initial presumption should be that all items are material.

Whatever the assumed relation between materiality and disclosure, the treatment of "footnote" liabilities possesses considerable significance. As evidenced by the nature of the items involved, many of them are material. The fact that the full disclosure of "footnote" liabilities leads to at least proportional changes in total assets in many instances is irrelevant. The basic objective is interfirm comparability.

In order to point up the significance of this matter and to establish a common reference point, our initial step is to examine both the diversity of treatment of "footnote" liabilities and the extent of their disclosure. Assuming intercompany comparability to be the underlying consideration, uniformity of treatment and disclosure are necessary complements. No disclosure whatsoever satisfies the uniform treatment criterion in a literal sense, whereas full disclosure without uniformity requires needless readjustments and has misleading implications.

Evidence signifying the inadequate disclosure of "footnote" liabilities is found in the American Institute publication, *Accounting Trends and Techniques*. Table I, derived from the 1952 Edition, treats lease obligations, pension costs, and contingent liabilities and suggests that a substantial majority of the published statements provides little or no information concerning these items. For those instances in which details are furnished, the data are frequently either incomplete or inappropriate for analysis by the reader. To illustrate by reference to the pension cost category: Past service costs may be undifferentiated from current service costs; the basis for their calculation may be undisclosed; and unfunded past service commitments may not be divulged.

TABLE I
DISCLOSURE OF "FOOTNOTE" LIABILITIES IN 1951 ANNUAL STATEMENTS

	Lease Obligations	*Pension Costs*	*Contingent Liabilities**
Details given	61	262	237
Simple reference, no details	139	89	143
No reference	400	249	220
Totals	600	600	600

* Due to the nature of The American Institute's breakdown, these figures may not be entirely correct.
Source: American Institute of Accountants, *Accounting Trends and Techniques*, 6th Ed., Nov., 1952.

A sample of eighty annual reports for 1953, selected on a quasi-random basis, reflects both diversity of treatment and inadequacy of disclosure.[4] Tables II and III, based upon this sample, treat pension obligations, lease arrangements, capital expenditure commitments, and other contingent liabilities and relate the nature of their disclosure to its location in the annual statement. Inasmuch as several items of information may be disclosed in a single annual statement and the data may be located in two or more places, e.g., footnote and stockholder's letter, the grand total at the lower right corner of each table exceeds the number of sample reports. The 1953 Annual Report for General Motors, for example, discloses annual pension costs and past service costs in a footnote, reveals the total assets held by the pension trustee in the stockholder's letter, and provides a liability reserve for employes' benefit plans in the balance sheet.

Elimination of this multiple disclosure factor from Table II accentuates the diversity of treatment. Footnote treatment is accorded pension commitments in twenty-five annual statements, with additional data provided elsewhere in nine

[4] In examining the accompanying tables, it should be remembered that variations in the degree of disclosure are one aspect of diversity of treatment.

TABLE II

DISCLOSURE OF PENSION DATA IN EIGHTY ANNUAL STATEMENTS FOR 1953

	Location of Data				*Total Number of Cases*
	Foot-note	*Stockholder's Letter*	*Balance Sheet*	*Income Statement*	
Total Annual Payment	18	5	—	7	30
Past Service Payment	13	—	—	—	13
Total Unfunded Past Service Cost	19	1	—	—	20
Total Funded Amount	2	3	—	—	5
Liability Reserve	—	—	12	—	12
Current Liability	—	—	1	—	1
Undetailed	2	7	—	—	9
None	—	—	—	—	29
Total Number of Cases	54	16	13	7	119

Source: *Annual Reports*, 1953, for eighty selected companies.

cases. Text treatment is accorded in sixteen reports, with supplementary information given elsewhere in nine instances. Balance sheet reserves are provided in twelve statements, with additional detail located elsewhere in six cases. Twenty-nine reports contain no information on pension commitments.

For lease, capital expenditure, and other commitments which are treated in Table III, footnote treatment appears to predominate. The principal deficiency is clearly that of inadequate disclosure. Forty-two annual statements either contain no reference to these items or provide no specific details concerning them. For most of the remaining reports, both the diversity and paucity of detail suggest incomplete disclosure.

From the sample of eighty annual statements, it appears that the interpretation of "footnote" liabilities is rendered unnecessarily difficult by a failure, in the majority of instances, to key footnotes to specific balance sheet items. The reader is thus left to his own devices to judge which segments of the balance sheet are affected. Minimum disclosure standards would seem to require that expert opinion be given by the accountant as to those asset, liability, and proprietary accounts which are conditioned by the existence of "footnote" liabilities.

The materiality of "footnote" liabilities

TABLE III

DISCLOSURE OF "FOOTNOTE" LIABILITIES OTHER THAN PENSION COMMITMENTS, IN EIGHTY ANNUAL STATEMENTS FOR 1953

Nature of Disclosure	*Location of Data*				*Total Number Cases*
	Foot-note	*Stockholder's Letter*	*Balance Sheet*	*Income Statement*	
Minimum or Annual Rentals	13	—	—	2	15
Capital Expenditure Commitments	11	2	—	—	13
Other Commitments (Detail Given)	4	—	—	—	4
Contingent Liabilities (No Details)	23	1	3	—	27
None	—	—	—	—	28
Total Number of Cases	51	3	3	2	87

Source: *Annual Reports*, 1953, for eighty selected companies.

which are not disclosed can only be inferred by reference to those which are revealed. Armco Steel, Chrysler, and United States Steel indicate that the unfunded portions of their past service costs, at the end of 1953, respectively amount to $44,500,000, $90,000,000, and $49,600,000. Sears-Roebuck reports that, as of December 31, 1953, minimum rentals prior to the year 2000 total $234,954,000. Pacific Gas and Electric, in its 1953 Report, refers to firm commitments which aggregate $100,672,000. Although these examples are clearly exceptional, they serve the purpose of emphasizing the potential significance of undisclosed items.

In the light of the preceding discussion, it seems evident that the "footnote" liability problem is one of major proportions. It is also apparent from the diversity of treatment that recommendations for change will not be unduly hampered by traditional practices.

Proposals to amend the treatment of "footnote" liabilities should take account of the existing state of affairs, the responsibilities of the accounting profession, and the purposes of annual statements. Given the prevailing state of affairs, the essential requirement seems to be more adequate disclosure, whatever the manner of presentation. Once this step is taken, uniformity of treatment becomes highly relevant.

The concept "more adequate disclosure" does not necessarily imply more detailed financial statements. Many of the items which are now shown separately in annual statements can readily be combined without greatly affecting disclosure. Of the ten asset items shown in the 1952 balance sheet for Radio Corporation of America, four amount to less than one per cent of total assets. Of the eleven asset items shown in the 1952 balance sheet for United States Steel, five amount to less than one per cent of total assets. The widespread utilization of even a one per cent rule-of-thumb as a basis for determining materiality would drastically alter the appearance of balance sheets.

Nor does more adequate disclosure necessarily involve the explicit recognition of normal commitments which arise in connection with the purchase of raw materials and the maintenance of plant and equipment. Disclosure of such commitments is desirable, provided the policies of a given company are noticeably different from those of other companies in the same industry and provided significant deviations from past levels occur in any period. As long as the deviations remain insubstantial, it is probably sufficient for the firm simply to specify the nature of its normal commitments periodically.

The existing state of affairs imposes two additional requirements. First, the failure to disclose commitments apparently assumes such proportions that auditing firms ought to include a specific statement in the annual reports concerning their efforts in this direction. The report reader then at least knows where he stands. Second, significant changes in the nature and degree of disclosure merit detailed explanation. If possible, the effect on previous statements should be noted in order to satisfy the continuity objective.

Members of the accounting profession are the recognized experts in the field of financial reporting. Ordinarily their word in both presentation and disclosure must be taken as gospel. Because of the accountant's authoritative and responsible position, every action assumes special interpretive significance. The relegation of certain items to footnotes suggests that either they are subdivisions of items shown in the balance sheet or that they are not really assets or liabilities at all. The outright omission of items suggests in turn either that no asset or liability exists or that it is immaterial.[5]

[5] For an item to be immaterial, moreover, it must

logically be less important than any item already reflected in the balance sheet.

To point up the implications of footnote treatment, let us examine the case of unfunded past service costs for pension programs. Let us accept the proposition that these costs are liabilities and assume that, while referred to in footnotes, they are not explicitly recognized in the balance sheet. Since each liability item in the balance sheet already has a distinct purpose, pension liabilities must be an unsegregated portion of the "retained earnings" account. At this point, a logical inconsistency arises between the implied treatment and the matching of past service costs against future income. To the extent that pension liabilities are viewed as an element of the "retained earnings" account, it follows that they are to be matched against past income.

It is not our purpose to dispute the American Institute ruling that past service costs should be matched against future income. The essential point is that in establishing a pension program a corporation accepts certain responsibilities which are not faced by firms without such programs and which have already been met by companies with fully funded programs. Unfunded past service liabilities should therefore be recognized and, if they are to be charged against future income, an associated asset item should be recorded. If no associated asset item exists, it is improper to match past service costs against future income.

The same argument applies to other footnoted commitments. The income statement implies one treatment; the balance sheet another. It is clearly evident that the accountant is not living up to his responsibilities in this area.

As long as corporations are expense-conscious and desirous of minimizing the flood of requests for further information, multi-purpose reporting appears inevitable. The consequence of multi-purpose reports is that footnotes and tables which both explain and itemize the more general balance sheet accounts serve a legitimate function. Footnotes which extend beyond itemization and elaboration and suggest that the balance sheet is incomplete cannot be justified on this basis.

In analyzing the prevailing use of footnotes, we are reminded strongly of the clean *versus* dirty surplus arguments.[6] As is evident from the published income statements of recent years, the clean surplus proponents have prevailed. It seems reasonable to believe that a similar line of thought can be applied to the case of footnotes with ultimately successful results. Prior to attaining the eminently desirable position of *clean* footnotes, however, the tendency toward more complete disclosure may well compel the adjustment of accounting standards by producing ever muddier footnotes.

At least two diversionary factors, in addition to the restraints imposed by tradition, retard acceptance of the proposition that "footnote" liabilities should be included in the balance sheet proper. One relates to the uncertainty surrounding both the amount of the liability and the appropriate valuation and nomenclature of the associated asset item, if one exists. The other concerns the point of delineation between liabilities and non-liabilities and, for that matter, assets and non-assets.[7]

Uncertainty with respect to dollar

[6] The essential point, in the writer's opinion, is that the reader of published statements is likely to be misled and the income figure may be subject to manipulation unless allowable charges to surplus are carefully defined. It is clearly the accountant's responsibility to interpret data even to the extent of showing *current operating performance*, but this can be done whether the income statement is of the *all-inclusive* or *current operating* type.

[7] Assets and liabilities refer, in this context simply to those items which are accorded balance sheet recognition, as opposed to those which are not recorded.

amounts is neither a novel nor a sound argument for subordinating liabilities, i.e., definite commitments requiring future cash outlays, to footnotes. This circumstance confronts the accountant in the case of Estimated Federal Income Taxes, in the case of most assets other than cash, and elsewhere. As long as the estimates are made with reasonable care and their basis disclosed, the accountant's responsibility is fulfilled. For large corporations, errors may be offsetting, thus giving the aggregate data greater reliability than the individual components.

The nature of the over-all valuation problem suggests that the proper emphasis should be upon interperiod changes, rather than upon absolute figures. That is to say, the data contained in published financial statements may be viewed as rough approximations to index numbers.[8] If such is the case, the accuracy of the assigned values becomes less important than the reliability with which the figures reflect changes. Whatever the presumption in this respect, however, "footnote" liabilities merit recognition.

Uncertainty as to the purposes for which published financial statements are to be utilized occasions a further dilemma. By way of illustration, unavoidable or minimum pension commitments which are the appropriate valuation from a liquidation point of view are likely to be substantially different from expected future pension outlays based upon a going concern point of view.[9] Uncertainty of this variety is not a sufficient condition for either the subordination or the omission of items. What appears to be desirable is a careful analysis of the purposes for which balance sheets are (or should be) utilized, a consistency of approach, and a presentation of alternative valuations.

The delineating point between items which do and do not merit balance sheet recognition is more difficult to resolve. Commitments made by corporation executives range from those which are definite, written, and irrevocable to those which are indefinite, oral, and not legally binding. Narrow, legalistic interpretations of liabilities are likely to be insufficient, provided the balance sheet is viewed as an essential complement to the income statement and is designed to reflect known factors which will affect future profits and cash requirements. Any attempt to establish precise standards for the recording of liability items is limited by the fact that the gradation from definite to indefinite may be continuous.

Post-war developments accentuate this problem and will continue to do so. The popularity of lease arrangements, when coupled with their omission from the balance sheet proper, conditions interfirm and intertemporal comparisons.[10] The increasing significance of private pension programs produces similar consequences. Exclusion of past service liabilities from the balance sheet proper, taken in conjunction with the diversity of funding provision, leads to heterogeneous results.[11] The possibility of "guaranteed annual wages" renders the problem even more acute.

Assuming the principle of comparability to be the fundamental consideration, two

[8] This point of view is implied in the position taken by J. B. Canning. See, for example, J. B. Canning, *The Economics of Accountancy* (New York: Ronald, 1929), p. 41.

[9] To cite a specific example, the *Agreement and Declaration of Trust* (as amended June 18, 1951) pertaining the Employee's Retirement System of General Mills. Inc., states that: "It is the intention of the Company to continue the Retirement System and make its contributions regularly each year," but ". . . The Retirement System may be terminated at any time by the Board of Directors of General Mills, Inc." without legal liability.

[10] See A. M. Cannon, "Danger Signals to Accountants in 'Net-Lease' Financing," *The Journal of Accountancy*, Apr., 1948, pp. 312–20, for a comparison of pre- and post-war data for major chain retailers.

[11] The essential justification for current funding is that the corporation may be better able to finance pension requirements now than later. As the program is funded, certain fixed costs are eliminated and additional flexibility is introduced. A corporation with a fully funded program is clearly better off than one whose program is either unfunded or partially funded.

propositions can be derived with respect to the appropriate dividing line between liabilities and non-liabilities. First, items which indicate material differences among firms should be accorded balance sheet recognition. Second, underlying similarities of purpose or function rate precedence over external dissimilarities in determining what should be recognized. Minimum standards of conduct require at least that items which are disclosed in the balance sheet proper under one guise are not to be omitted when clothed in another garment. In the case of private pensions plans, this requirement presupposes that past service commitment be treated as a liability item, that the basis for calculating these commitments be revealed, and that the total assets held by the pension trustee be disclosed.

Unfortunately the comparability principle is not the only issue at stake. Before matters relating to the cut-off point in the liability chain can be resolved satisfactorily, explicit recognition must be given to certain basic areas of confusion. One relates to the essential difference between going concern (and, in some instances, economic) values and legal (and, in some instances, liquidation) values. The historical tendency in accounting has apparently been to emphasize legal and liquidation values in the case of liability items and going concern and economic values in the case of asset items.[12] This tendency, as related to liability items, is currently reflected in the valuation of debts according to their principal amounts without reference to time, in the disclosure of minimum, inescapable liabilities, e.g., minimum rentals, in the recording of preferred stock at its liquidation value, and so on.

In all probability the emphasis upon legal values, without reference to time, more directly influences the level of recorded liabilities than the number of liability items to be accorded balance sheet recognition. In order to make the balance sheet as meaningful as possible, and despite the heterogeneity of asset and liability items, going concern values are generally preferred whenever they differ markedly from legal values. A possible exception arises in connection with the utilization of discounted present values. Given the subjective nature of capitalization rates, it may be desirable to record the actual commitment and to include sufficient data for the examiner to do his own discounting.

The other, and—for our purposes—more relevant, area of confusion relates to the apparent belief that the ownership of assets is somehow different from control over assets. Although direct titles to assets are customarily given explicit balance sheet recognition, the same treatment is rarely afforded contractual agreements which transfer control without title. The balance sheets of two identical corporations may exhibit substantial differences, provided one chooses to purchase and the other to lease (no matter how binding the lease.)[13] As long as an asset item remains unrecorded, it follows of course that the associated liability item will receive the same treatment.

From a realistic point of view, that which imparts value to an asset is the stream of future services to be obtained through its utilization.[14] The unique benefits attributable to direct ownership are permanence of control and absence of restrictions over use. These benefits may in-

[12] The recognition of economic values is, for the most part, a one-way street and results from the application of the doctrine of conservativism. Unrealized losses are often recorded, but such is rarely the case with unrealized gains.

[13] Actually, the American Institute takes an intermediate position by stating that: "... where it is clearly evident that the transaction involved is in substance a purchase, the 'leased' property should be included among the assets of the lessee with suitable accounting for the corresponding liabilities and for the related charges in the income statement." See ARB #43, *op. cit.*, p. 127.

[14] See J. B. Canning, *op. cit.*, pp. 19–22, for a similar point of view.

crease the stream of future services over what it would be in the event an asset were merely controlled through lease or other arrangement, but they do not alter the essential character of the stream. As a result, the advantages peculiar to ownership cannot be accepted as a sufficient basis for recognizing directly owned assets in the balance sheet proper, as opposed to the non-recognition of controlled (but not owned) asssets.

Granted the validity of the preceding argument, contractual arrangements which raise the streams of future services above what they would otherwise be should logically be accepted as balance sheet components. It follows in turn that the associated commitments should be treated as liability items.

Comparability is the guidepost of financial reporting. In the absence of well-defined, absolute standards, the performance of a given firm can be judged good or bad only in the light of historical results or of the behavior of other firms. The essential purpose of financial reporting must clearly be to facilitate the task of relative measurement.

Based primarily upon this premise, several proposals for changes in the treatment of "footnote" liabilities have been suggested in the preceding discussion. Of fundamental importance is the need for more adequate disclosure. The concept "disclosure" implies purposeful presentation, as contrasted with a simple elaboration of details. Of interpretative significance is the desirability of limiting the use of footnotes to the presentation of non-substantive matters. Footnotes may legitimately be employed to itemize recorded assets and liabilities and to divulge alternative valuation bases, but not to reveal unrecorded assets or liabilities.

Given a proper understanding of the "retained earnings" account, the footnote treatment of liabilities which are to be charged against past income may not be unduly misleading. If the footnote is keyed to the "retained earnings" account and is clearly labeled, its interpretation is likely to be correct. When footnote treatment is afforded liabilities which are to be charged against future income, the implied meaning leaves much to be desired. Footnote treatment, in this case, neglects both the associated asset item and the effect upon total assets and liabilities.

Before the "footnote" liability problem can be resolved satisfactorily, the distinction between assets and non-assets needs to be clarified. To a significant extent the reluctance of accountants to recognize "footnote" liabilities appears to be attributable to the fact that, although the commitment appears definite, the asset item does not conform to standard patterns.[15] It is suggested in the preceding analysis that control over future streams of services, rather than direct ownership, should be the essential criterion for asset recognition. This criterion appears to cover many of the *now* doubtful cases. In order to allow for the omission of certain items on a consistent basis, standards which govern normal commitments and minimum materiality should also be established.

In some instances, the omission of liabilities is justified by accountants on the basis that no definite value can be assigned them. Outright omission is, however, one of the least desirable methods of resolving valuation difficulties.

To conclude with an optimistic note, the diversity of treatment of "footnote" liabilities suggests that the situation is not hopeless. It is possible to find cases where both the disclosure and treatment of "footnote" liabilities are very near to adequate. In addition, improvements often occur with relative rapidity in the absence of hard and fast rules.

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[15] In some instances the converse is also the case.

APPLICABILITY OF THE REALIZATION PRINCIPLE TO MONEY CLAIMS IN COMMON DOLLAR ACCOUNTING*

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THIS PAPER questions the validity of the application of the realization principle to money claims in common-dollar accounting. The topic is important not only because common-dollar accounting is complex enough without the introduction of any additional complications, but also because such application of the realization principle demonstrates that it is still not fully understood.

DEFINITION OF TERMS USED

"Common-dollar accounting" refers to the branch of accounting that attempts to remove the distorting effects of changes in the general level of prices by stating *all* accounting magnitudes in terms of dollars having the same purchasing power. Such procedure is to be sharply distinguished from the adjustment of only depreciation and inventory charges. It is true that depreciation and inventory consumption charges may be converted into figures having more current significance than the original dollar figures. It is *not*, however, true that these are the only adjustments that need to be made to arrive at a figure for income undistorted by changing general price levels. The common-dollar accountant attempts to determine "undistorted" income by adjusting *all* balance sheet and income statement magnitudes not already expressed in terms of the dollar whose purchasing power is used as the standard of account.

A very important difference between common-dollar adjustments and other methods of adjustment for inflation arises in the case of "money-value items" or "money claims," as they will be called throughout the remainder of this paper. These "money claims" comprise cash and all items requiring the payment of a definite fixed number of dollars by or to the business unit. Examples are cash, accounts receivable, accounts payable, debentures, and preferred shares. Those who would adjust only depreciation charges and inventory consumption charges recognize no gain or loss on money claims as the result of inflation. The common-dollar accountant, on the other hand, recognizes the gain or loss in purchasing power. An example will make this difference clear. In Exhibit I, the cash account of a hypothetical company is summarized both as it appears on the books and as it would appear in the calculations of the common-dollar accountant. In the column headed "Mixed Dollar" (so named because the dollars have different purchasing powers) is presented a summary of the figures that would appear in accord with present "original dollar" records. The business began the year with $1,000 in cash, acquired an additional $6,000 in cash during the year, and had a total of $7,000 in cash at the end of the year. Assume, however, that at the beginning of the year the purchasing power of the dollar could be represented by an index number of 76 and that throughout the year purchasing power rose by 2 points

* The author is grateful for assistance received from Professors G. Heberton Evans, Jr., and Sidney Davidson of The Johns Hopkins University.

a month until it was 100 at the end of the year (i.e., prices have fallen from 132 to 100, purchasing power being the reciprocal of prices). If the common-dollar accountant were to summarize the cash account and were to use the purchasing power of the dollar at the end of the year as his common denominator, his calculations would appear as in the last column headed

EXHIBIT I
CASH ACCOUNT

	Mixed Dollar	*Dollar of 12/31/X1*
Opening balance	\$1,000	\$ 760
Additions During Year	6,000	5,280
Gain in Purchasing Power		960
Closing Balance	\$7,000	\$7,000

"Dollar of 12/31/X1." In terms of the year-end dollar, the opening balance had a purchasing power of only \$760 (\$1,000 multiplied by 76 and divided by 100). Similarly, the additions to the cash balance, which, for simplicity, have been assumed to flow in evenly throughout the year, may be expressed as \$5,280 since they were acquired when the dollar had an average purchasing power of 88 (\$6,000 multiplied by 88 and divided by 100). But here is a seeming conundrum! In terms of year-end dollars, the business began with \$760; acquired \$5,280 more, and so might be expected to end the year with \$6,040. But it actually has \$7,000 and, of course, each of these seven thousand dollars has the same purchasing power as any other dollar prevailing at the end of the year. The difference of \$960 is the increase in the purchasing power as a result of the decline in prices.

Most dollar accountants in America have added one further refinement—or complication: they have asserted that part of the gain or loss is "realized," and part "unrealized." In terms of the example, they have attempted to divide the \$960 into realized and unrealized portions.

HISTORICAL NOTE ON THE APPLICATION OF THE REALIZATION PRINCIPLE TO MONEY CLAIMS IN COMMON-DOLLAR ACCOUNTING

As applied in Germany during the inflation immediately following World War I, the common-dollar approach made no use of the realization principle. Any gain, for example, which might arise from the decrease in the burden of debt resulting from the runaway inflation was thought to apply to the period in which the prices "ran away," and not to the period when the obligations were actually settled.

Henry W. Sweeney described the German experience to American accountants in articles appearing in 1927,[1] and in 1928.[2] Subsequently, a letter commenting on these articles referred to an example in Sweeney's later article, in which the gain resulting from the decreased burden of bonds payable was displayed as part of income. The writer suggested that the inclusion of this gain might amount to recognizing an *unrealized* gain in the sense that *price movements might reverse in the near future*. He then suggested that the unrealized gain be excluded from income, remarking that in this manner adherence would be had to "sound accounting principles, which require that provision be made for all possible losses and that no unrealized gain be taken up in profits."[3]

Sweeney's reply justified the German exclusion of any reference to the realization principle on the ground that, as the inflation got out of hand, there was less and less reason for expecting a reversal of the price level, and therefore there was little reason for distinguishing between

[1] "Effects of Inflation On German Accounting," *Journal of Accountancy*, Vol. XLIII (1927), pp. 180–190.

[2] "German Inflation Accounting," *Journal of Accountancy*, Vol. XLV (1928), pp. 104–116.

[3] J. H. Allen, Correspondence: "German Inflation Accounting," letter dated March 3, 1928, and appearing in *Journal of Accountancy*, Vol. XLV (1928), p. 310.

realized and unrealized gains. Sweeney did not question his critic's interpretation of the realization principle; he did not question the bearing of the possibility of future losses on the realization principle. He closed with the remark: "Mr. Allen's suggestion seems quite sound . . . with regard to present orthodox accounting theory, and would have to be considered very carefully if any adaptation of German methods were to be attempted in this country."[4]

In a subsequent article appearing in this REVIEW, Sweeney discussed the application of the realization criterion in more detail.[5] The possibility of future losses offsetting past gains was considered relevant to the realization criterion. As applied to money claims in common-dollar accounting, any past gains or losses from price movements were in danger of being wiped out by future reversals of these price movements, and should, therefore, be considered as unrealized.

In a book appearing in 1936, Sweeney introduced the realization principle as follows:

> "The usual attitude is that income is not realized until an article or service has been sold and delivered to some one outside the enterprise at a price above cost."[6]

While pointing out the difference between a realized and unrealized gain, Sweeney did not underline the fact that the principal purpose of making this distinction is to enable the unrealized gain to be excluded from income. There was reason in this neglect of emphasis. As will presently be seen, there are sound reasons why the allegedly unrealized gain on money claims *must* find its way into the income statement. Sweeney, apparently recognizing this necessity, promptly proceeded to undermine the realization principle on a number of grounds. He pointed out that there were at least two generally accepted exceptions to the realization principle, and then made the comment that the conventional applications of this criterion resulted in one period not receiving credit for income that had been earned but not realized, and a later period receiving this credit when the income was realized but not earned.[7] He then suggests, in effect, that the accountant should go to the trouble of computing what part is realized and what unrealized, but should ignore the practical significance of this distinction by throwing both into income:

> "The practical way of overcoming the artificiality caused by classifying income into realized and unrealized is a simple one. . . . It consists, first, in using a realized-income section the contents of which are identical with those in the ordinary profit and loss statement. Second, an unrealized-income section is added because of the helpful information that it contains. Finally, at the very bottom of the profit and loss statement the total of the realized and unrealized income is shown. This total is called, 'Final Net Income For the period'."[8]

Others made use of this distinction with some misgiving. Said Ralph C. Jones in 1935: "It may be argued that this loss is unrealized which perhaps is true. . . . "[9] But, while apparently attaching some significance to this application of the realization criterion, he was not willing to fly so in the face of traditional accounting practice as to then include "unrealized income" on the income statement. He therefore excluded both the realized and unrealized gain or loss from the changing purchasing power of money claims en-

[4] "Correspondence: German Inflation Accounting," letter dated March 14, 1928, and appearing in *Journal of Accountancy*, Vol. XLV (1928), pp. 310–311.

[5] "The Technique of Stabilized Accounting," ACCOUNTING REVIEW, Vol. X (1935), pp. 185–205.

[6] *Stabilized Accounting* (New York: Harper and Brothers, 1936), p. 20.

[7] *Ibid.*, pp. 20–21.

[8] *Ibid.*, p. 21.

[9] "Financial Statements And The Uncertain Dollar," *Journal of Accountancy*, Vol. LX (1935), p. 183. Later he refers to such losses as "not necessarily realized," p. 194.

tirely from the income statement, showing such gains and losses as surplus adjustments. This treatment, of course, does not answer the problem, but merely avoids it. *All* the gain or loss from changes in the value of money is still recognized, being merely excluded from the income statement, and tucked away in the reconciliation of surplus. In a later article, Professor Jones made no reference to an "unrealized" portion and included the total amount of gains and losses on money claims in the income statement.[10]

Most writers, however, have not been able to shake off this erroneous application of the realization criterion. States one:

> "These conceptions [of realized and unrealized income in conventional accounting] can be readily applied to the gains and losses resulting from changes in the value of the dollar. For example, the gain resulting from an increase in the purchasing power of the dollar subsequent to the acquisition of a sum of cash is unrealized so long as the cash continues to be held, and is realized—brought to a final determination—when the fund in question is expended. Similarly the gain or loss in purchasing power attaching to accounts receivable or other claims to dollars as a result of a falling or rising price level is unrealized so long as the resource stands in its original form and is realized upon collection or other disposition."[11]

He, too, includes the supposedly unrealized gains but does not present them in the income statement, preferring to present them mingled in with realized gains and a number of other items under the caption "Conversion Adjustment."

The Committee on Concepts and Standards Underlying Corporate Financial Statements of the American Accounting Association says in its Supplementary Statement No. 2 on "Price Level Changes And Financial Statements": "When the general price level is rising, corporations derive gain (*realized or unrealized as may be*) from any excess of liabilities . . . over assets fixed in dollar amount."[12]

Another common-dollar accountant in a recent article writes with reference to losses in purchasing power of money claims:

> "Some of these losses are unrealized, according to the usual tests of realization, but they exist nevertheless. Only the future will reveal whether they will be offset by later gains. If the general price level were to fall and the company's monetary position to remain positive, gains would ensue. It is the contention of this writer that both the losses and later gains (if any) should be reported, rather than be ignored in the hope of late offsets."[13]

Again, a distinction is made, and nothing is done with it.

Other common-dollar theorists, while not intrepid enough to say what is realized and what unrealized, have excluded both realized and unrealized gains and losses from the income statement only to include them, crytpically or otherwise, on the balance sheet.[14]

THE EFFECT OF ASSUMPTIONS CONCERNING THE FLOW OF MONEY CLAIMS

The computations involved in, and the debate aroused by, any decision to distinguish between a "realized" and an "unrealized" portion of this purchasing power gain are formidable. Expenses and revenues must be split into realized and unrealized portions. The income statement must have a realized and an unrealized

[10] Ralph C. Jones, "Effects of Inflation on Capital and Profits: The Record of Nine Steel Companies," *Journal of Accountancy*, Vol. LXXXVII (1949), pp. 9–27.

[11] William Andrew Paton, *Advanced Accounting* (New York: Macmillan, 1941), p. 739 in Ch. XXXIII "Common-Dollar Reporting."

[12] Accounting Review. Vol. XXVI (1951), pp. 468–474, above quote on p. 472, italics supplied.

[13] Donald A. Corbin, "The Impact Of Changing Prices On A Department Store," *Journal of Accountancy*, Vol. XCVII (1954), p. 435.

[14] See, for example, Paul Grady, "A Proposal For The Adoption Of Standards of Disclosure For Changing Price Levels," *Journal of Accountancy*, Vol. XCIV (1952), pp. 565–569; and Russell Bowers, "Business Profit and The Price Level," Accounting Review, Vol. XXVI (1951), pp. 167–178, particularly p. 171.

portion. On the balance sheet, there must appear "realized retained earnings" and, in addition, "unrealized retained earnings."[15] But this is only the first step into a quagmire of controversy.

To determine the so-called unrealized gain, i.e., the gain attaching to the money claims remaining in the business, it is necessary to decide just which money claims do remain in the business. Are they the money claims most recently received? Or have the most recently received money claims left the business as fast as they came in, leaving the money claims acquired some time in the past?

If, for example, it is assumed that the cash remaining at the end of the year is the most recently received cash, then a "first-in, first-out" (FIFO) flow of cash through the business is involved. But if the cash is supposed to follow a "last-in, first-out" (LIFO) flow, the unrealized gain will be quite different.

Suppose that, for the hypothetical cash account presented above, the $6,000 addition to cash occurs at the rate of $500 a month, this $500 being the excess of receipts of $1,000 over disbursements of $500. The supposedly realized and unrealized portions of the gain in purchasing power are presented in Exhibit II for both

EXHIBIT II

REALIZED AND UNREALIZED PORTIONS OF GAIN IN PURCHASING POWER OF CASH HELD

	FIFO	*LIFO*
Realized	$470	$ 0
Unrealized	490	960
Total Gain	$960	$960

the FIFO and the LIFO assumption. The unrealized gain in accordance with the FIFO assumption may be explained as follows: The cash on hand at the end of year consisted of the cash receipts of $1,000 per month of the preceding seven months. The receipts of the month of June were acquired when the purchasing power of money was 87 relative to the index of purchasing power at the end of the year. (The money is assumed to flow in evenly throughout the month.) In terms of year-end dollars, these receipts were $870 and grew in purchasing power by $130 to $1,000 by December 31. The gain from holding the cash acquired in July was $110, for August $90, and so on down to the $10 gain resulting from holding the $990 of purchasing power acquired in December until it had $1,000 of purchasing power in year-end dollars. The total of these gains is $490, which is the unrealized gain shown in Exhibit II. The other figures may be similarly computed. Under the LIFO assumption, the gain in this example is, of course, entirely unrealized because the cash disbursed in each month—the cash on which a gain could have been realized—is the cash most recently acquired in that month and has not, therefore, enjoyed any gain in purchasing power.

According to FIFO, about half of the gain is realized. According to LIFO, none of the gain is realized. It is by no means easy to decide whether FIFO or LIFO is the most applicable assumption!

Sweeney did not state explicitly his assumptions about what constituted the closing balance of cash, receivables, and other money claims. Moreover, he based his computations on two different assumptions. In most cases he assumes that cash follows a FIFO flow so that the closing balance is the cash most recently acquired by the firm.[16] In one example, however, he uses a sort of "average" flow concept according to which the closing balance consists of cash received at the average

[15] For an illustration of how complicated such a distinction can make the simplest of statements see *Stabilized Accounting, op. cit.*, p. 27 or any of the later examples.

[16] *Stabilized Accounting, op. cit.*, pp. 71, 119, etc.

price level prevailing throughout the year.[17]

A more recent writer, recognizing this difficulty, has explicitly made the FIFO assumption, viz., " . . . all elements pass through the business in regular order, the oldest item in each case being used or retired first."[18]

Other assumptions are just as reasonable. Suppose a corner grocer receives cash from his customers. He puts the dollar bill in his till on top of the other dollar bills that have been there some time. When he makes a disbursement, the grocer, thinking it makes no difference to his income which dollar bill he uses, follows the most convenient practice, which is to take out the bill on top of the stack. He thereby confronts the common-dollar accountant with a LIFO flow of cash.

It is much more difficult to determine the flow applicable to a bank balance. It is not possible to scrutinize the debits appearing on a bank's books to tell to what credits they refer.

It has become fashionable in recent years to contend with regard to LIFO, FIFO, and other such calculations that the important thing is not the actual physical flow of goods through the business, but rather the order in which costs should be recognized regardless of which particular units leave the business.[19] The important thing is not the physical identity of the goods leaving the business, but the "correct reporting of periodic income." But on what grounds can it be argued that one flow of money claims is more conducive to the "correct reporting of periodic income" than another? Such considerations are particularly inappropriate since the common-dollar accountant does not—*indeed cannot*—omit the so-called unrealized portion of such gains or losses from his calculations of income or of retained earnings. The change in proprietorship as calculated by the common-dollar accountant is the same whether the closing cash balance is thought to be the cash balance with which the year began or whether it is thought to be the cash received from the transactions of the most recent months.

What is the usefulness of this distinction between two portions of the loss or gain from holding cash balances during a period of changing prices? With reference to the unrealized portion of the income statement, Sweeney has spoken of "the helpful information that it contains." Nobody has yet attempted to define just what "helpful information" it contains. The corner grocer may welcome figures showing the cost of holding cash in his till; these figures will be useful to him in determining the benefits to be derived from building a "hedge" against inflation. But he is likely to be sceptical of the importance of any distinction between realized and unrealized portions, particularly if the amounts of these portions depend on how deeply he reaches into his till when making disbursements, or if they depend on the opinion of his accountant as to when it is most useful to consider his closing cash balance as having been acquired. The grocer is likely to be particularly doubtful if, after carefully making the distinction and after computing a "realized" and an "unrealized" portion, then the accountant makes no use of the

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[17] It is not a thoroughgoing "average" flow as he apparently assumes that the only disbursement which took place in this simplified example—a dividend disbursement at the end of the year—consisted of the full opening balance plus a portion of the year's receipts. To the extent that the full opening balance was included in the dividend payment and none of it was included in the closing balance, he is following not an "Average" flow concept, but a FIFO flow concept. See *Ibid.*, pp. 21–22.

[18] W. A. Paton, *op. cit.*, pp. 740–741. See also p. 746.

[19] Nevertheless, there is force to the argument that: "Economic flow may not jibe with physical flow from the standpoint of all possible theoretic conceptions, but the burden of proof should fall very heavily on those who insist on the adoption of any accounting procedure which can be demonstrated to be fundamentally at odds with the data of physical inspection and experience, the data of competent engineering." William A. Paton, "The Cost Approach to Inventories," *Journal of Accountancy*, Vol. LXXII (1941), p. 302.

distinction by asserting that both the realized and the unrealized portion have equal weight in the determination of income or of the final retained earnings balance.

THE REALIZATION PRINCIPLE IS APPLIED IN A MANNER INCONSISTENT WITH ORTHODOX ACCOUNTING THEORY

This refusal, indeed inability, to do anything with the distinction between a realized and an unrealized gain is even more disturbing than the absolute dependence of the calculations on equally plausible flow assumptions giving widely diverging answers. As noted above, the distinction between a realized and an unrealized gain was made for the very purpose of adhering to "orthodox accounting theory." But on what grounds can the inclusion of an unrealized gain in income be considered as consistent with "orthodox accounting theory?"

An example will clarify why the common-dollar accountant must include both the realized and unrealized portion in his income statement. Exhibit III presents the opening and closing balance sheets of the hypothetical company whose cash account and whose gain in purchasing power has been previously analyzed. The first two columns present the opening and closing balance sheets as they are traditionally presented by expressing the various accounts in terms of different types of dollars. The highly simplified income statement that might correspond to these balance sheets is as follows:

Sales	$12,000
Expenses	6,000
Net Income	$ 6,000

(For greater simplicity, expenses and expenditures have been made the same, as have revenues and receipts.)

The last two columns of Exhibit III present the same facts but measure the facts by use of the same type of dollar—the dollar which corresponds to the dollar prevailing at the date of the final balance sheet. The income statement that corresponds to the "common-dollar" balance sheets is as follows:

Sales	$10,560
Expenses	5,280
Operating Profit	$ 5,280
Gain in Purchasing Power of Money Claims	960
Net Income	$ 6,240

For convenience, sales and expenses were assumed to occur evenly throughout the year so that sales, expenses, and net operating profit could be expressed in terms of the closing balance sheet's dollar by multiplying each of these figures by 88 (the average purchasing power of the dollar during the year) and dividing by 100 (the purchasing power at the end of the year). The

EXHIBIT III

HYPOTHETICAL COMPANY

Balance Sheets

	Mixed Dollars		*Dollars Of 12/31/X1*	
	12/31/X0	*12/31/X1*	*12/31/X0*	*12/31/X1*
Cash	$1,000	$7,000	$760	$7,000
Total Assets	$1,000	$7,000	$760	$7,000
Capital Stock	$1,000	$1,000	$760	$ 760
Net Income		6,000		6,240
Total Equity	$1,000	$7,000	$760	$7,000

gain in purchasing power is, of course, the same gain previously computed.

Suppose that it is desired to exclude the allegedly unrealized portion of the gain. Using the FIFO assumptions outlined above, the income statement appears as follows (with sales and expenses omitted):

Operating Profit	$5,280
Realized Gain in Purchasing Power	470
Net Income	$5,750

In accordance with such a concept of income, the closing balance sheet would appear as follows:

Cash	$7,000
Total Assets	$7,000
Capital Stock	$ 760
Net Income	5,750
Total Equity	$6,510

Before the accountant pockets the extra $490, he might pause to ponder why his balance sheet does not balance. When the accountant picked a figure for cash he quite correctly felt that the best figure for this purpose was the actual amount of cash held. Expressing it in current dollars presented no problem since a sum of cash held in any particular time is already expressed in the dollars prevailing at that date. But this procedure amounts to including in the cash figure the full increase in its purchasing power. When the accountant computes the stockholders' ownership in this company, however, his calculations imply that only part of the increase has occurred. The increase in purchasing power is thus automatically included in the assets section of his balance sheet, but no one has been given a claim against the allegedly unrealized portion.

A similar contradiction does not arise in the application of the realization criterion to inventories in conventional accounting. If the realization principle as applied to inventories is really applicable to the purchasing power of cash balances in common-dollar accounting, it ought to be possible to apply the same accounting techniques to both. All that is required is that the closing cash balance must not include the unrealized portion of the gain. This purpose may be accomplished by carrying cash on the closing balance sheet at $6,510, which figure is the purchasing power at which this final cash balance was acquired.

It may readily be seen why the common-dollar accountants have chosen to include the so-called unrealized gain in their computation of net income. They have based their calculations on the very sound belief that the only sensible figure at which to report the current cash balance was the actual amount of cash held and that the purchasing power in which this cash should be expressed was the purchasing power prevalent at the date of the balance sheet.

This striking discrepancy between the conventional and the common dollar applications of the realization principle raises the question as to whether there is any real parallel here on which to base a distinction between a realized and an unrealized portion of the purchasing power gain.

MISINTERPRETATION OF THE REALIZATION PRINCIPLE

The common-dollar accountants previously quoted have left little doubt about their interpretation of the realization principle. They have considered gains and losses to be unrealized as long as the possibility of future events which might offset these gains or losses existed. They have justified their extension of the realization principle on the ground that until the money claim is disposed of, any gain or loss may be wiped out by subsequent contrary movements of prices.

It is, of course, undeniable that subse-

quent losses may wipe out previous gains. This is true of any asset retained in, or liability owed by, the business. It is also true no matter what the form in which they are retained in the business. Suppose Company A owes some accounts payable during a period of rapid price rise. If these accounts are still outstanding at the end of the period, most previous common-dollar accountants would not recognize any gain on them because they had not been disposed of, and the gain would therefore be subject to "offset" by subsequent declines in the price level. Suppose Company B is in the same position, but on the last day of the year gives a note payable in exchange for its accounts payable. The account payable has now been discharged and, according to most common-dollar accountants, the decline in the purchasing power of that debt may now be recognized as a gain. But is disposal really a good criterion if this is the true meaning of the realization criterion? Is Company B really in a different position from Company A with regard to the realization of income? Is not the note payable given in exchange for the accounts payable just as subject to gain or loss from changes in the price level as are the undischarged accounts payable of Company A? If the true meaning of the realization principle is that gains should only be recognized under circumstances that preclude subsequent losses, then disposition of a money claim has no particular significance. Banks, insurance companies, factors, trust companies, all are as subject to gains or losses from changing price levels and these gains or losses are always subject to subsequent offset even though an asset may be held as cash one day, disposed of in exchange for a receivable the next, temporarily invested in a bond the next. . . . The only time when a gain or loss could be legitimately recognized if most common-dollar accountants' interpretation is correct would be when the business was finally liquidated or when it took a step in that direction by, for example, using cash to pay off its outstanding notes payable. But by such a date the information that common-dollar calculations would render is of more historical than decision-making interest.

This erroneous interpretation of the realization principle has gained some ground in conventional accounting with regard to securities. The Securities and Exchange Commission rules with regard to investment companies require that where securities are carried on the balance sheet at market value, the excess of market value over cost be treated as "unrealized appreciation." "Realization" has not occurred until securities are sold.[20]

An illustration readily reveals the fallacy of this rule. "A" Investment Company and "B" Investment Company both bought stock in the XYZ Corporation on the same day for $20 per share. At the end of their fiscal years (which occurred on the same date for both), the stock was worth $50 a share. That morning, "A" sold its stock for $50 a share, and that same afternoon bought back the same number of shares in the same company for $50 a share. "B" retained its stock but elected to carry it on the balance sheet at value. According to S.E.C. regulations, "B's" gain is unrealized. But "A," which only differs from "B" by having paid commissions to get out of, and then back into, the stock, has "realized" a gain. Both are subject to subsequent loss, both paid the amount per share, and both end the period with shares having the same value. What is the value of a rule which states they are in different positions?

The interpretation of the realization

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[20] Securities and Exchange Commission, "Regulation S-X, Form and Content of Financial Statements, As Amended To and Including November 3, 1953" (Washington: Government Printing Office, 1954), pp. 30, 32, 34, 36, 37, 38, 39, 53.

criterion in "orthodox accounting theory" has rather been that no gain should be recognized until the amount of the gain in terms of the unit of account—dollars—may be objectively determined. For this reason, the conversion of assets into cash and receivables has always played a central role in the realization of income. One text, for example, states: "The sale, which usually implies the delivery of goods or the rendering of services to the customer in exchange for *cash or receivables*, is the most commonly accepted criterion, but it is by no means the only basis which is or should be used."[21] According to *A Dictionary For Accountants*, the word "realize" may be defined as follows: "to convert into cash or a receivable (through sale) or services (through use); to exchange for property which at the time of its receipt may be classified as, or immediately converted into, a current asset."[22]

The sale of the asset for cash or receivables is not always essential, but it is necessary that no gain be recognized until objective evidence exists as to the amount of that gain in the unit of account, namely dollars. Gain may be recognized for the accrued interest on a bond held, or gain may be recognized on the part of profit attributable to the completed portion of a long-term contract. Arguments have also been advanced for pricing certain inventories at a market value above cost, thus recognizing a profit, where the value of these inventories in terms of the unit of account is subject to little or no doubt. For example:

> "It may be possible to justify an exception [to cost or market whichever lower, where cost is difficult to determine] in cases involving fungible items in the hands of the original producer when a fixed price is established by public market quotations. On this premise, a farmer's inventory of grain or a producer's inventory of crude oil could conceivably be stated at market (less delivery costs). Gold and silver, which have a fixed monetary value and no expense of selling, clearly may be stated at such monetary value."[23]

Securities need be no exception to this rule. Under many conditions, cost is the best and most objective evidence as to the value of a security. To the extent that securities are traded on an organized exchange so that the amount of cash for which they may be sold may be readily ascertained, and so that the commission that would have to be paid for such sale is open to no doubt, to that extent there is good ground for including these securities in the balance sheet at their market value, and for recognizing the gain.[24] If market value may be ascertained with sufficient certainty and objectivity to justify its inclusion on the balance sheet, there is no excuse for asserting that the excess of this market value over cost is inferior to other business gains by attaching the label "unrealized."

In all cases, the proper use of the realization criterion ought to involve the recognition of no gain unless the amount of the gain is definitely known and can be translated into the unit of account, namely the monetary unit. The possibility of future offsetting losses has no relevance.

This orthodox treatment of the realization criterion, where gain must not be recognized until translatable into the unit of account, is in strong contrast to the pseudo-application of the criterion where the gain must not be recognized until the money claims leave the accounting entity. In the pseudo-application, the gain is "re-

[21] Perry Mason and Sidney Davidson, *Fundamentals Of Accounting, 3rd Ed.* (Brooklyn: Foundation Press, 1953), p. 156. Italics supplied.

[22] Eric L. Kohler, *A Dictionary For Accountants* (New York: Prentice-Hall, 1952), p. 354.

[23] Maurice N. Stans, "Inventory Pricing," *Journal of Accountancy*, Vol. LXXXI (1946), p. 105.

[24] For a concurring argument read Perry Mason's dissent to *Accounting Research Bulletin 43* of the Committee on Accounting Procedure of the American Institute of Accountants (New York: 1953), p. 41.

alized" not through the receipt of cash or receivables, but through the exchange of such items as cash and receivables for other assets. Not sale, but purchase becomes the criterion of realization.

The correct interpretation of the realization criterion with regard to money claims in common-dollar accounting, is, of course, quite different. Money claims are expressed in terms of general purchasing power. If the amount of that purchasing power changes as a result of price movements, a gain or loss has occurred. *All* that gain or loss has been realized in the only sense in which it will ever be realized: namely, through a decline in the general purchasing power of money claims held, and *not* through the disposal of these money claims for some specific assets. This interpretation accords well with common sense: for the gain or loss results from *holding* money claims during a period of changing prices, not from *disposing* of the money claims at some particular level of prices.

CONCLUSIONS

1. An incorrect interpretation of the realization criterion underlies the application of that criterion to the gain or loss from holding money claims during periods of changing prices.

2. Any attempt to apply this false interpretation will result in complicating common-dollar financial statements, and in arousing an extended discussion about which of a number of flow concepts is most appropriate.

3. No matter how much of the gain or loss is thought to be realized and how much is thought to be unrealized (and the magnitudes of the two portions will vary greatly depending on what flow concept is adopted), both portions *must* be included in the determination of proprietorship if the money claims are to be presented in the balance sheet at the amount of purchasing power which they represent at the balance sheet date. But if such allegedly unrealized gains are included in the determination of income, then this application of the realization criterion is in conflict with orthodox accounting theory and with the more traditional applications of the realization criterion.

4. The correct interpretation of the realization criterion indicates that *all* the gain or loss in purchasing power has been realized through the possession at the end of a period of money claims having a different purchasing power than when they were acquired.

These remarks do not imply any disrespect for either the realization criterion or for common-dollar accounting, but are meant to discourage a promiscuous mingling of the two.

BROAD VS. NARROW CONCEPTS OF INTERNAL AUDITING AND INTERNAL CONTROL*

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THE EXPANSION of business and the introduction of the corporate form of business organization long ago forced the separation of the investor from management. This divorce of investors from management, together with the demands of creditors, led to the development of periodic audits by independent outside public accountants. This same expansion of business with the resultant departmentalization and specialization by operation and by function, has also led to a widening gap between management itself and the operating units of the business. To bridge this gap and effectuate better management control there have been developed various forms of internal control, of which internal auditing is a part.

A small business which is personally managed and directed by a single individual who has direct contact with all its operations may be likened to the pedestrian making a trip between two designated points. The manager, like the pedestrian, has direct personal knowledge at all times of progress made and present position. On the other hand, the management group in a large corporation, with departments and branches, and having employees numbered in the hundreds or thousands, may be likened to the operators of a modern bombing plane. Both have, by force of circumstances, been separated from direct personal knowledge of progress made or present position. In the operation of the bomber it has become necessary to provide instruments for control, to utilize flight plans made in advance of take-offs, to assign duties to different crew members in such way as to interrelate their activities, to arrange for interchange of information between crew members, to prepare flight logs and make useful references thereto, and to observe certain points of reference for guidance in navigation. The management of the large corporation has likewise been forced to adopt means of overcoming its lack of personal knowledge of business operations. Thus internal control came into being.

The subject of "Internal Auditing and Internal Control" supplies us with a broad base from which to operate in our discussion here today. Perhaps some brief definitions of terms will be helpful to our purposes. It seems that there are two somewhat different concepts of internal control which we should recognize in our discussion. The narrower of these two concepts appears in the definition of the term in auditing texts. For example, Culey and Bauer give the following definition: "The methods and arrangements within a company that are set up to safeguard cash, merchandise, and other assets, to provide checks on the accuracy of the records, and to promote clerical efficiency and compliance with company policies.[1] The concept incorporated in this definition seems to approach the meaning expressed in the older term "internal check," and has a fairly direct relationship to financial records and reports. It emphasizes the safeguarding and compliance aspects of internal control.

* This paper was presented at the Sixth Annual Meeting of the Southeastern Group, University of Florida, May 7, 1954.

[1] Roy T. Culey and Royal D. M. Bauer, *Auditing*, (1953), p. 84.

Eric L. Kohler, in his ***Dictionary for Accountants***, describes internal control as "The general methodology by which management is carried on within an organization; also any of the numerous devices for supervising and directing an operation or operations generally." Clearly this sets forth a broader concept of internal control than does Culey and Bauer's definition. Kohler also elaborates his definition with a list of elements contributing to internal control. In this list internal check is given as one of eight elements. Internal auditing is also listed as one of the eight elements, but I think we must recognize today that the purpose of internal auditing is not solely to prevent or detect fraud, safeguard assets, promote clerical accuracy and efficiency, or assure compliance with company policies. Kohler's other elements, such as: (1) development and maintenance of functional lines of authority, (2) clear definition of duties and responsibilities, with no overlapping or undefined areas of responsibility, (3) accounts for accurate and complete information, (4) a structure of reports for presenting this information, (5) budgeting, and (6) coordination of all controls to stimulate and take advantage of natural attributes of employees which might eliminate the need for some controls or limit the extent or rigidity of others, are certainly not primarily aimed at safeguarding assets or checking compliance. Their contributions are towards getting instructions or information to the right parties at the proper times, keeping lines of authority clear and effective, creating and supplying employees with norms or standards for their activities, and providing measurements of operations useful in the control of business activities.

In any discussion of internal control and internal auditing it should be recognized that internal control has the broader meaning I have presented. Internal auditing activities also extend in a large measure into this broader field of internal control.

Auditing texts are replete with illustrations of internal control procedures as applied to particular phases of business activity. Transactions involving cash, or items readily convertible into cash, receive most attention in these illustrations and the emphasis is on the internal check features of internal control. An illustration involving a coal mining company and its employee housing facilities may serve to indicate the application of internal control in another field and to emphasize the broader concept of internal control.

This company had grown from a small unit with one mine and a very limited number of employees into an operation with six large mines and about twenty-five hundred houses for use by its employees. There existed little control with regard to this housing. As originally set up the mine superintendent could perhaps have had direct contact with practically all operations of the company, including the limited amount of housing it provided for its employees. With the growth of the business this of course became impossible, and the outside foreman at each mine was given complete authority in connection with the housing. His duties in this connection included: repairing the houses, assigning persons to houses, reassignment to larger or smaller units, tearing down of houses, removal of employees from houses, and all other matters relating to housing activities. All this he did without requirement of records or reports, and without the necessity for approvals. He did inform the mine office of rents to be collected from employees as payrolls were distributed. However, in connection with rents to be collected there were no leases used, no record was made of what house any employee was placed in, and no system was provided for assuring that only employees be placed in the houses. In fact, while the cost of the houses had been set up in an

asset account as they were constructed, and depreciation was being taken on this cost, there was no scheme provided whereby any record would show how many houses, or which particular houses, were still serviceable. This information may have been within the personal knowledge of the outside foremen at a given mine, but even this is doubtful in view of the four or five hundred houses at each mine and the various factors which might result in loss or disrepair of the houses. Some, of course, had been destroyed by landslide, fire, storm, etc., but no procedures followed by the company gave the foreman any occasion to concern himself with such events so long as he could find houses to place employees in.

Obviously the thing which was lacking, and sorely needed here was of an accounting nature, at least in part. The bookkeeper for this company had started with the concern when it operated only the one small mine. He had grown up with the company as it expanded, but his growth had been stunted and one-sided. While he would normally have been in the best position to see the need for records and reports dealing with the housing operations, and to introduce such records and reports, he was purely a bookkeeper and was burdened with routine duties to such an extent he had found no time to devise such control measures, if the need had ever occurred to him.

Clearly the lack of an adequate system of procedures, accounts, and reports made it impossible for top management in this company to know that company property was being properly safeguarded, that its policies were being followed with regard to rent charges per room or in the assignment of employees to designated houses, or even that the company was actually receiving rent for all occupied houses or that only employees were placed in the company houses. There was no record of what particular house any employee occupied, no inspection of houses by anyone other than the outside foreman, no system of reporting of abandoned or destroyed houses, and no provision of approvals of any action taken by the foreman with regard to housing.

This company needed better property records in which the houses were identified and described. A system of reporting on destruction or abandonment of houses, on the basis of which they could be removed from the property records, was essential for control. A formal leasing system with written documents signed by the employees and approved by proper company officials (in addition to the foreman) should have been set up. In these leases the terms and conditions of the leasing agreements should be set forth and the leased houses adequately identified. In addition to serving a useful purpose in assuring understanding of the lease arrangements these leases would constitute an integral part of the system of internal control whereby only employees would be permitted to rent houses and rental scales adopted by the company would be definitely observed. The number of rooms an employee occupied and for which he should be paying rent would be known because the house he occupied would now be clearly identified. This system would also provide an official record to support the collection of rents and to serve as evidence of the amounts of rent which should have been received. These records, together with a system of periodic inspections of the housing units by some person other than the outside foreman, with a separation of the rent collection and the recording thereof, and supplemented by a system of periodic reports on house occupancy, repair costs, and abandonments or losses, would provide management of the mine company with a much more adequate basis of control over its housing.

What I have been trying to show is that a greal deal of internal control is for pur-

poses other than internal check. Internal control is also designed to effectuate company policies, evaluate activities, direct activities along the most efficient lines, and inform proper parties promptly of undesirable trends. It is in this area that budgetary control and the utilization of operating standards are effective elements of internal control.

Internal auditing is a part of internal control in both the narrow sense and in the broader sense which I have described. While the first concern of internal auditing in most concerns is with verification of completed transactions and records, it actually extends far beyond this. Two of its added features are (1) the responsibility of the internal auditor in connection with the development and maintenance of internal check procedures and devices, and the periodic appraisal of their adequacy, and (2) his duty to check periodically on the adequacy of pre-audit procedures and their effectiveness in operation. He is also charged with the responsibility of reviewing policies, regulations, financial practices, and operations generally as an aid to management. Internal auditing is defined by the Institute of Internal Auditors as "the independent appraisal activity within a business organization, established for the review of the accounting, financial, and other operations as a basis for protective and corrective service to management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. While it deals primarily with accounting and financial matters, it may also deal with matters of an operating nature." Under this definition the internal auditing function is clearly much more than a review of arithmetical accuracy or a police action to keep everyone honest. It is also depicted in this definition as a positive and dynamic influence in business providing liaison between management and the individual operator.

Heckert and Willson list the following types of functions which may be performed by the internal auditing department:[2]

1. Appraisal of procedures and related matters. This activity may involve several related phases, including:
   a) Expressing an opinion as to the efficiency or adequacy of existing procedures.
   b) Developing new or improved procedures.
   c) Appraising personnel.
   d) Interchanging ideas as between plants, and perhaps standardizing on the best method.
2. Verification and analysis of data. Here also, this function may be subdivided into two or more parts, such as:
   a) The review of data produced by the accounting system to ascertain that the reports are valid.
   b) The making of further analyses, as required, to support given conclusions.
3. Activities verifying the extent of compliance. This may involve determining that:
   a) Accounting procedures or other policies are being followed.
   b) Operating procedures are being followed.
   c) Governmental regulations are being complied with.
   d) Other contractual obligations are being observed.
4. Functions of a protective nature. This would include at least three subdivisions:
   a) Prevention and detection of fraud and dishonesty.
   b) Review of care taken of company properties.
   c) Check of transactions with outside parties, e.g., determining that all shipments are billed to customers.
5. Training and other aids to company personnel. This is particularly applicable to accounting personnel.
6. Miscellaneous services. Included are special investigations, and assistance to outside contacts, such as the public accountant.

In one organization with which the speaker is familiar the internal auditing department has attached to it a staff of "auditors" whose sole duty it is to visit the forty-two installations of the firm and take physical inventories of supplies and parts. This is the only physical inventory of these

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[2] J. Brooks Heckert and James D. Willson, *Controllership*, p. 517.

items which is taken by this firm and it is used for verification and correction of book inventory figures maintained for each installation. The function of these "auditors" is not limited to verification of the records, however. They also perform functions of a protective nature since their work may prevent or detect fraud or dishonesty and they are also expected to review the care taken of the property which they are inventorying.

The relationship of internal auditing to internal control and the wide range of functions to be performed by the internal auditing staff have practical implications with regard to the organizational position of the auditing department within the business. This department should have an independent status to insure its impartiality. It should, preferably, be under the direction of and report directly to the chief accounting officer, or possibly the treasurer if he is not the chief accounting officer. It should have no responsibility for the performance of duties the results of which it is to review. Likewise, it should have no authority over any department even where in performing its auditing functions it is dealing with such departments or their employees and is possibly making appraisals of operations thereof.

Those employed in the internal auditing department must be well informed regarding the operations of the business, the organizational structure of the business, and the accounting system used. Of course they should be well trained in the particular auditing techniques they must use in their particular function and should be adequately guided and supervised in their work. The inventory auditors referred to earlier were drawn by the company from its own staff of storekeepers and were therefore familiar with the specialized parts and supplies used by this company. In the area of guidance and supervision in the internal auditing department the adoption and use of audit programs may be very useful. This is particularly true where the business operates a number of branches and uniform audit procedures are sought for purposes of comparison even though different persons may have to perform the audits at different branches. As in all audit operations, the auditing staff should be cautioned not to let the audit program, if used, restrict their ingenuity and thereby result in inadequate appraisals of activity.

To the extent that internal auditing operations are performed for the purpose of providing verification of compliance, or for the purpose of preventing fraud, inefficiency, or inaccuracies, it is directly affected by the effectiveness of other measures of internal control. In this respect the guiding principles for the auditor are very similar to those which guide the outside public accountant in performing an audit. In the performance of its functions not aimed at compliance, or the prevention of fraud, etc., it is quite obvious that the internal auditing department cannot place similar reliance on other internal control measures. Such is the case in connection with appraisals of procedures or personnel, developing new or improved procedures, performance of special investigations of various kinds, or analysis of data for specific purposes not contemplated in the established reporting plan. In these areas the internal auditor must be capable of bringing to bear analytical abilities of a high order and must be possessed of good judgment.

From what has been said concerning the nature of internal control and internal auditing it becomes apparent that each is in some ways dependent on the other. Internal auditing contributes to internal control, and many internal control devices condition the work of the internal auditor. Both are far more than procedures to assure mathematical accuracy or keep everyone honest.

ACCOUNTING TEACHERS' LIBRARY

School of Business Administration, University of North Carolina

THE GRADUATE CLASS in Accounting Systems included in its accounting exhibit for the dedication of the new buildings on May 25, 1953, an "Accounting Teachers' Library" of approximately 200 books and pamphlets, most of them recent editions, in accounting and related fields. This Library was on display at the annual convention of the American Accounting Association last September.

The books were selected by Alton G. Sadler, Associate Professor, University of North Carolina, and were arranged for publication by Kenneth F. Easter, an M.B.A. Service Scholar.

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AMERICAN ACCOUNTING ASSOCIATION COMMITTEES

POLICIES AND PROCEDURES

THIS STATEMENT is intended to be a general advisory statement of procedures and relationships which Association experience has demonstrated to have value for the assistance of future Presidents and Executive Committees. To a considerable extent, these regulations represent the rules under which the present and previous Executive Committees have operated. They are not intended to bind future Executive Committees, since each succeeding Executive Committee has the right to determine the rules under which it, the officers, and Association committees will operate, within the by-laws. Apparently any action of a prior Executive Committee can be considered to be accepted and adopted by implication by a subsequent Executive Committee unless the latter specifically alters it. Although the setting up of regulations for committee operations is highly desirable, care must be taken not to accomplish by indirection what is not permitted by the by-laws.

I. SELECTION OF COMMITTEES

A. *General*

The By-laws provide: "The administration of the affairs of the Association, except as otherwise provided herein, shall be vested in an Executive Committee consisting of the officers and the three ex-presidents last holding office," and "The Executive Committee shall establish committees as it deems desirable." "Committee members shall be appointed by the President, and may be removed by him at his discretion."

B. *Task Committees*

The President may be given the authority to create new education task committees with the advice of the Joint Committee on Education.

C. *Joint Committee on Education*

It is recommended that the chairmen of the underlying task committees be ex-officio members of the Joint Committee on Education.

D. *Composition of the Membership of Committees*

The observance of the following general standards is recommended, as far as feasible, in the selection of members for committees:

(1) Only one representative from any one school should be placed on any one committee.

(2) With the exception of the Director of Research, a person should be limited to membership on one committee, in addition to membership on the Joint Committee on Education, the Membership Committee, the Nominations Committee, and the Executive Committee.

(3) Only members of the American Accounting Association should be appointed; committees may have non-member consultants, however, if the Executive Committee approves the idea and the consultant.

(4) Membership of the committee should be rotated slowly (a) to get new ideas, and (b) yet to retain continuity.

(5) No one should be appointed who has commitments to jobs or other organizations which are incompatible or which might cause embarrassment to the Association or to the proposed appointee.
(6) Reasonable representation to individual interests, geographical areas, types of institutions, and academic and nonacademic groups should be provided.

II. REIMBURSEMENT OF EXPENSES

It is the responsibility of the Executive Committee to budget an aggregate amount for committee activities, travel, and meeting expenses. The apportionment of the total among the several committees may be delegated by the Executive Committee to the discretion of the President. It is recommended that members of each committee be reimbursed in accordance with the following regulations.

A. It is the policy of the American Accounting Association to reimburse members for expenses incurred in attending committee meetings held on days other than those of the annual convention. If a committee has met at convention time and has had to arrive early or stay after the convention, in order to attend a committee meeting, the Association will reimburse its members for their costs of food and lodging for the extra days.

B. Ordinarily, first class train fare and lower berth will be considered the maximum amount to be reimbursed for transportation; however, the cost of a roomette will be allowed when a lower berth is not available. Where the distances are great, the member is justified in using air travel. For short distances (up to approximately 300 miles), he may desire to travel by private automobile; in such instances he is entitled to a reimbursement allowance per mile, seven cents per mile being suggested at the present time. For longer trips by automobile he is entitled to a maximum amount equivalent to first class (lower berth) railroad fare, except in unusual cases when the seven cent rate will be allowed.

C. The following information is to be included in the request for reimbursement: name and address, name of committee, dates and place of meeting, and a "breakdown" showing totals for each of meals, hotel, transportation, and miscellaneous.

D. The expense reimbursement request should be transmitted through the committee chairman, who should initial it as authorization to the Treasurer to make the reimbursement. Executive Committee members should send their requests directly to the Secretary-Treasurer.

E. If a committee member is making a multi-purpose trip, only part of which is on American Accounting Association business, he will be reimbursed for food and lodging for the time spent at the committee meeting, plus a pro rata share of transportation costs (including meals). Proration may be accomplished by any method which is equitable in the particular situation.

III. SOLICITATION OF FUNDS

Only the Executive Committee may formally solicit funds from outside sources to carry on research, committee work, or other activities of the American Accounting Association. This provision applies to all committees, without exception. No committee or committee member has implied authority to compromise the position of the American Accounting Association or the Executive Committee on such matters.

On occasion, the Executive Committee may specifically authorize a particular committee to explore informally the possibility of obtaining funds, but even then the particular committee may not prepare and submit directly to the intended donor an application for such funds or in any other way attempt to commit the American Accounting Association. An application, if made, will be made in the name of the American Accounting Association by the Executive Committee.

IV. MEETINGS

In general, each committee should meet a maximum of three times a year, one of which will be at the annual meeting. It is recommended that each committee meet at least once a year—at the annual convention; other meetings may be held at American Accounting Association expense only with prior authorization of the President.

V. ACTIVITIES

It may be desirable for chairman of some committees to meet with the President or the Executive Committee at the December meeting of the Executive Committee before the start of the year of their terms of office, in order to get acquainted with their jobs and to discuss a program for their committees for the new year.

VI. REPORTS

Each committee, through its chairman, is expected to prepare a written report three weeks before each Executive Committee meeting. Twelve copies of these reports should be prepared and distributed, as follows:

(a) To the President (1).
(b) To the Secretary-Treasurer for filing in the permanent files in the American Accounting Association business office (1) and for distribution to the Executive Committee (9).
(c) To be retained by the committee chairman (1) as part of the cumulative files of the committee.

The education task committees, however, are to report to the Chairman of the Joint Committee on Education, and his committee is to present its report (incorporating all or parts of the reports of underlying task committees) in twelve copies, as suggested above.

Committee reports are to be published only if publication is authorized by the Executive Committee. The Executive Committee will neither rewrite nor censor committee reports, but will pass on them in a general way. Such reports as are published will be published as reports of the committee involved and not as those of the Executive Committee or the American Accounting Association.

VII. FILES

At the end of the year, each committee chairman should be instructed to send pertinent files of the committee to his successor, a copy of the transmittal letter being sent to the Secretary-Treasurer for the permanent files of the committee in the business office.

VIII. RECORD OF MEMBERS' COMMITTEE ACTIVITIES

In January of each year, the Secretary-Treasurer should make a record upon a member's ledger card of any committee assignments, offices held, or other services to the American Accounting Association by the individual member. This record should be useful to future newly-elected presidents in the selection of committee members and to future nominations committees.

Committee on Policies and Procedures
CHARLES J. GAA, Chairman
GEORGE R. HUSBAND
JOHN A. WHITE

REPORT OF THE ANNUAL CONVENTION

R. C. Cox
Secretary-Treasurer

THE 1954 annual meeting of the American Accounting Association was the largest and one of the most successful in its history.[1] It was held on September 1 and 2 in Urbana, Illinois, with the College of Commerce and Business Administration, University of Illinois, as host.

Since previous issues of the ACCOUNTING REVIEW have carried the complete convention program, only a few brief comments need be made in this article concerning it. On Tuesday, August 31, the University of Illinois was host serving a delightful picnic supper at the Illini Grove.

The ladies' program, in addition to the activities provided on Tuesday, included a luncheon and card party at the Allerton Mansion and a tour of the estate, followed by a reception at the Illini Union on Wednesday. A luncheon and style show were held on Thursday. Activities of children, in addition to the picnic, consisted of a visit to the University farms and other points of interest, games, movies, and other entertainment provided at the Lincoln Avenue Residence Hall.

At the business meeting and luncheon on Wednesday, Dean Paul M. Green made a welcoming address, and brief reports were given by the Editor regarding the ACCOUNTING REVIEW, by the Secretary-Treasurer regarding finances and membership statistics, and by the Director of Research concerning the Association's activities in this regard. President Smith discussed the Association's Price Level Research Study and told of publication plans. He also summarized work of Association committees and reported on the AIA Council meeting and the vote of the Association on a West Coast meeting. A moment of silence was observed in memory of those members of the Association who had died since August 31, 1953.

After the banquet on Wednesday evening, President Smith introduced the members of the Committee on Convention Arrangements, the Ladies' Program Committee, and the persons seated at the speakers' table. President Lloyd Morey of the University of Illinois gave a very interesting talk, in which he traced the growth and development of the American Accounting Association. The Alpha Kappa Psi award was made to Professor A. C. Littleton for his contribution to the field of accounting.

The Committee on Nominations (composed of S. Paul Garner, Russell H. Hassler, George R. Husband, Howard S. Noble, and Thomas W. Leland Chairman), nominated the following persons, who were subsequently elected:

President—Willard J. Graham, University of North Carolina
Vice-President—Martin L. Black, Jr., Duke University
Vice-President—Arthur M. Cannon, University of Washington
Vice-President—Donald P. Perry, Lybrand, Ross Bros. & Montgomery, Boston
Secretary-Treasurer—R. Carson Cox, Ohio State University
Director of Research—John A. White, University of Texas
Editor of the ACCOUNTING REVIEW—Frank P. Smith, University of Michigan

[1] The following statistics may be of interest:
Registrations included 379 members, 140 wives, and 59 children, a total of 578.
The ladies reported attendance of 93 and 112 at their two luncheons; the members, 330 and 303. There were 480 at the banquet. Only the nursery program (attendance 2) was below expectation.

President-elect Graham made a brief acceptance speech. Following the banquet session, the AIA film, "Accounting the Language of Business," and other films were shown. The Illinois Society of Certified Public Accountants entertained at an informal dance and other diversions held in the Illini Union Commons following the banquet session.

President Arthur B. Foye, of the American Institute of Accountants, gave a very interesting and timely address at the final luncheon session of the convention on Thursday.

One of the interesting aspects of the convention was the large number of persons who traveled great distances in order to be with us. The following is a partial list of those from outside the continental United States:

Jacob Adler	University of Hawaii, Honolulu
Wilfred Berman	Dalhousie University, Halifax, N. S.
Tsang-Young Chang	Sin Chu Coal Mining Ad., Sin Chu, Formosa
Tsung-Shu Chang	Civil Aeronautics Admin. Taipei, Formosa
Ramon Hermida	Panama, Panama
Tze Chang Hsu	China Navigation Co., Formosa
Chu-Chain Hwang	Bank of Communications Taidei, Formosa
Adonai Ibarra	San Jose, Costa Rica
Yuen Kung	MOEA, Formosa
Kiyoshi Kurosawa	Yokohama University, Yokohama, Japan
Nancy Fen Lee	Taiwan Agricultural & Chemical Works, Formosa
Yu Fu Liang	Taiwan Industrial & Mining Corp., Taipei, Formosa
Joseph L. Sheng	Taiwan Cement Corp., Taipei, Formosa
David Solomons	London School of Economics, London, England
Yu Chun Wang	Taiwan Agriculture & Forestry Corp., Formosa

The Association is greatly indebted to the Committee on Arrangements and the Ladies' Program Committee for the excellent facilities and arrangements made for us. We would like to express our sincere appreciation to all of the staff members of the College of Commerce and Business Administration of the University of Illinois and especially to the committee members listed below:

Professor and Mrs. C. A. Moyer
Professor and Mrs. H. H. Baily
Professor and Mrs. N. M. Bedford
Professor and Mrs. H. E. Breen
Professor and Mrs. J. M. Carrithers
Professor and Mrs. R. I. Dickey
Professor and Mrs. C. J. Gaa
Professor Dorothy Litherland
Professor and Mrs. R. K. Mautz
Professor and Mrs. H. L. Newcomer
Professor and Mrs. K. W. Perry
Professor and Mrs. H. T. Scovill
Professor and Mrs. W. E. Thomas
Professor and Mrs. N. D. Wakefield
Professor A. R. Wyatt

THE TEACHERS' CLINIC

FRANK S. KAULBACK, JR.

EDITOR'S NOTE: Many of the experienced teachers, as well as some of the new ones have developed devices and techniques for the presentation of certain of the knotty aspects of accounting, and it is felt that such suggestions might well be made available to the other members of the teaching profession through *The Teachers' Clinic*, Accordingly, contributions are hereby invited. Please address all correspondence to Frank S. Kaulback, Jr., School of Commerce, University of Virginia, Charlottesville, Virginia.

A REVISED CONCEPT OF INVENTORIES

CHARLES W. BASTABLE, JR.
Columbia University

The development of the balance-sheet approach is justly regarded as a significant contribution to the teaching of accounting, in that it permits education in accounting to be developed logically, rather than by the study of a series of rules that can have little meaning until the complete accounting cycle has been presented. Nevertheless, the balance-sheet approach is not without its critics, most of whom are primarily concerned with the fact that this method tends to plant in the mind of a student the incorrect thought that a balance sheet shows what a business is "worth." There is a further criticism. The balance-sheet approach leads to automatic acceptance of some questionable concepts on inventories.

When assets are marshaled for inclusion in the balance sheet, it is logical to divide them into two principal categories—current and fixed. After all, there are in business a short-term cycle and a long-term cycle of capital recoupment, and the division of assets between current and fixed is a normal consequence. Inasmuch as inventories belong in the short-term cycle, they are classed as current assets. To a beginner, all of this is logical enough to merit acceptance. However, would it be so readily acceptable if the balance-sheet approach had not been employed?

As an alternative, the income statement might be used as the starting point in teaching accounting. If used, emphasis would necessarily be placed upon the proper measurement of income. In measuring income for a given period, charges against revenues would not include any expenditures that did not contribute to the earning of revenues. Inasmuch as closing inventories are costs that apply to revenues of future periods, they would have to be excluded from current income determinations. This would lead to recognition of the balance sheet as a temporary repository by means of which inventories are deferred to subsequent periods for proper income determination.

Obviously, there is a dilemma. Since inventories are costs applicable to future periods, should they not be shown under such a balance-sheet caption? Or, in line with present accepted practice, should they be shown as current assets?

In classifying inventories as current assets, there is the advantage of identifying them as belonging to the short-term cycle. A lesser consideration is that this classification is generally accepted today. There is, however, a rather important disadvantage. The grouping of assets under the "current" category implies homogeneity, but all current assets are not measured in the same manner. Receivables are stated at cash realizable value, whereas inventories usually are not.

There is other evidence to suggest the desirability of removing inventories from the current-asset category. The existence

of the Acid Test, as a supplement to the Current Ratio in financial statement analysis, indicates that there are times when it is desirable to remove inventories from the group of current assets.

The presentation of inventories outside the current asset group under a caption such as "Costs Applicable to Future Periods" has two advantages. First, it would emphasize the fact that inventories are charges against future revenues and that the balance sheet is a way station for the deferral of such items to subsequent income statements. Secondly, it would emphasize the underlying philosophy of inventory measurement; cost would be the proper basis for measurement, although conventions for determining cost would be just as necessary as they are now. The second advantage merits further consideration.

The American Institute of Accountants, in Accounting Research Bulletin No. 29, states:

(1) "A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues."

(2) "The primary basis of accounting for inventories is cost." These excerpts indicate that present accounting concepts on the measurement of inventories do not differ from the concepts that would apply if inventories were placed under Costs Applicable to Future Periods on the balance sheet. However, as inventories are now measured, there is a widespread use of the "lower of cost or market" rule. Is this rule sound?

There are two reasons for reducing inventories from cost to "market" (or replacement cost).[1] The first, which is not so commonly thought of, stems from a desire to match revenues against expenses in determining periodic income. While revenues and expenses are both expressed in dollars, it is desirable that the same kind of dollars be used for each. Reduction of a final inventory to "market" in a period of falling prices, when dollars are presumably worth more, means that the opening inventory of the following period will be stated in dollars that are more nearly comparable to dollars of revenue against which they will be matched than if original cost had been preserved. This results in an adjustment of sorts in periods of falling prices, but it does not provide for any further adjustment for price-level changes between the last inventory measurement and the final date on which the items in inventory are sold. Furthermore, it does not provide for any adjustment in periods of rising prices. During such times, what appears to be a net operating profit may in reality be a net operating loss that is offset by a greater gain due to a rising price level.[2]

The second reason is based on a desire to charge any loss—the difference between original cost and replacement cost—to the period in which such loss occurs. The loss may be caused by: (1) the random fluctuations of individual prices in a period of stable money; or (2) a general decline in the price level. In the first instance, a significant loss is possible only if the "lower of cost or market" rule is applied to each item

[1] It is believed that a third reason exists in many minds. As long as inventories are classified as current assets, there is the temptation to adjust them for any unrealized losses, in order to be conservative in the measurement of total current assets, which, when matched against current liabilities, give some measure of debt-paying ability. However, since the net cash ultimately realized on inventories will depend on a large number of other factors, it is hard to appreciate that "market" yields a better measurement than "cost."

[2] Admittedly, an accepted accounting axiom requires that no recognition be given to so-called unrealized profits, but this axiom is based upon the underlying assumption of a stable money. Price-level changes invalidate this assumption. The present concern over depreciable assets is a case in point. The recent upward trend of prices has focused attention on the fact that charges for depreciation in the income statement are not on a comparable dollar basis with revenues. Considerable study has been and is being given to finding a solution that meets with general acceptance. For the present, however, depreciable assets continue to be carried at cost.

in inventory. Otherwise, unrealized gains will tend to cancel unrealized losses, as happens when the rule is applied to the total of the inventory. Unless conservatism is a virtue, there seems to be little justification for the application of the rule to individual items. Despite the fluctuation of individual prices in a period of stable money, there is no real loss if the cost of replacing the entire inventory equals, or exceeds, original cost. Any loss which results from the application of the rule to individual items in a period of stable money, may be regarded as artificial, or at best inapplicable. The application of the rule to the total of the inventory appears more consistent with the position of a business concern as an operating entity. In the second instance, a loss due to a general decline in the price level, the rule will serve to charge such a loss to the period in which it occurs.

With regard to the question on the soundness of the "lower of cost or market" rule, one should be impressed with its limited applicability. It serves the single purpose of charging a price-level loss to the period in which it occurs. This is because present accounting principles, which are founded on the assumption of a stable money, are not adequate to cope with price-level changes. However, there are many other facets to the problem of price-level changes. Since the inappropriateness of the rule in dealing with some of these facets has been indicated already, it does not seem warranted to attempt to justify the existence of the rule on its ability to handle price-level changes. Therefore, the general soundness of the rule is open to serious question. To the extent that it is currently employed, it should be regarded as a temporary measure best suited to deal partly with general price-level declines.

Much has already been said about price-level changes with respect to inventories. Notwithstanding, there is a final point to consider. When inventories are compared with depreciable assets, it is at once apparent that price-level changes are likely to affect the latter much more significantly than the former. The period between acquisition and sale of inventory items is much shorter than the period between acquisition and final consumption of depreciable assets. If original cost can be countenanced as a proper basis for the measurement of depreciable assets, why should it not be acceptable for inventories, which are much less affected by price-level changes?

While cost is advocated as the proper measurement of inventory for the present, it is not regarded as the ultimate goal. When and if a satisfactory solution is found to the problem of depreciable assets and the changing price level, it seems entirely logical to apply the same type of solution to inventories, which are costs applicable to future periods just as depreciable assets are.

In summary, the following proposals are offered in connection with inventories:

1. Classify as Costs Applicable to Future Periods, rather than as current assets.[3]
2. Recognize original cost as the basis for measurement.
3. Disregard random individual price fluctuations.
4. Consider a modification of original cost only in cases where there is evidence of a change in the price level that is significant enough to warrant a change in the measurement of depreciable assets.

In considering the validity of these recommendations, the reader is asked to recognize that accounting thought is still in the formative stages and that present concepts may have resulted largely from

[3] It is contemplated that inventories, deferred charges, and depreciable assets would be shown under the heading of Costs Applicable to Future Periods.

the manner in which accounting study was channeled at the beginning. Therefore, the full significance of the recommendations can best be realized only if the effects of the balance-sheet approach are set aside temporarily.

THE MACHINE-GRADED TEST FOR ACCOUNTING COURSES

STUART B. MEAD
Michigan State College

In many schools the number of students enrolled in accounting courses, especially at the elementary level, places a heavy burden of paper work on the instructor. As a consequence, the daily quiz, so useful in measuring the progress of students, may be neglected. To some extent the machine-graded test may be used as a means of relieving the burden of paper work.

This type of testing is the familiar objective type of examination modified to fit the method of grading. The student answers the questions on a standard International Business Machines core sheet with an electrographic pencil. Various types of score sheets are available. This gives the instructor an opportunity to select one that will fit his need. The answer sheet is finally "graded" by a scoring machine. In the grading process the machine will give the number of correct answers, or it will score the number of incorrect answers. The instructor, from this information, may record the score in terms of the total number of correct answers, or he may record the net result (rights minus wrongs).

The machine graded test has two primary limitations. These are:

1. The cost of the scoring equipment. Because of this factor only schools that are able to make wide use of this type of testing can acquire the necessary equipment.
2. The necessity of testing large numbers if the complete value of the investment is to be attained. This limitation would make the method useful only in those accounting courses having large enrollments, primarily elementary accounting.

CONSTRUCTION OF THE EXAMINATION

As the work of the instructor is confined solely to the writing of the examination, extreme care must be exercised in the formulation of test questions. The questions must fit the available scoring forms. In other respects the techniques of constructing the test are much the same as those used for the objective type of examination. In fact, the machine-graded test is an objective type of examination with a machine relieving the instructor of the paper work.

All types of objective questioning may be adapted for the machine-graded test. As a means of avoiding memorization, the multiple choice, or completion type of question, is preferable to the true and false type. By the use of a code system, as illustrated below, the completion type of question is extremely useful under the machine-graded testing system.

Instructors find that most of the subject matter taught in elementary accounting is readily adaptable for the machine-graded test. Some of the most usable topics are: definitions, bookkeeping and accounting transactions, adjusting entries, bank reconciliations, and account classifications for statement purposes.

The test may also be used to check the arithmetical ability of the student. Under this heading would be the computation of the proceeds of a discounted note, interest

computations, computation of depreciation, computation of cost of goods sold, and the like.

Much material on the best methods of constructing objective test questions is already available. Because of the similarity of the two types of tests, further details regarding the writing of machine-graded test questions would appear unnecessary. An illustration of a completion question making use of a code is shown below.

MACHINE-GRADED TEST ILLUSTRATED

A question to test knowledge of balance sheet classification of accounts:

Statement Classification Code

1. Current asset
2. Deduction from a current asset
3. Fixed asset
4. Deduction from a fixed asset
5. Other asset
6. Current liability
7. Long-term liability
8. Net worth
9. Some other section of balance sheet
10. Does not appear in balance sheet

Question number	
1	Accounts Receivable
2	Supplies on hand
3	Capital stock
4	Building under construction
5	Furniture and fixtures
6	Land
7	Mortgage payable
8	Net profit
9	Unexpired insurance
10	Federal taxes payable

The above question is designed to be used with the standard International Business Machines form number 1100 A 151 or a similar one. This form provides 15 answer spaces and allows up to 100 questions to be answered. If correctly used, this proves to be an equitable means of testing and a great help to the overburdened instructor.

ACCOUNTING TRAINING FOR NON-ACCOUNTING MAJORS

Jim G. Ashburne
University of Texas

A periodic review of the objectives, content, and sequence of accounting courses in institutions of higher learning is consistent with generally accepted accounting principles.

As a vehicle for such a review a questionnaire was addressed to departmental chairmen in colleges and universities in the South and Southwest. The following remarks are based on 25 responses to this questionnaire.

The questions revolved around three points: (1) How much accounting can and should be required of all students in colleges of business administration? (2) Are our elementary courses suited to the needs of our captive audience? (3) What advanced training should be required for business administration students who do not wish to major in accounting?

With the idea of getting a sense of proportion, we asked respondents to indicate the average enrollment in their school or college of business and the average number of accounting majors in a long term. Their replies showed that 9 per cent of the population in our business schools are concentrating in accounting; 91 per cent are pursuing courses leading to business careers other than accountancy.

THE ELEMENTARY COURSE AND NON-ACCOUNTING MAJORS

Elementary accounting is a required course in all of the schools represented. This fact raises the question, "Should it

make any difference in the content and methodology of our first-year course that nine out of ten students enrolled for the course will not continue the study of accounting (a) unless they are required to, or (b) unless instructors can arouse a compelling interest in accounting during the first year. Can we serve accounting majors and one-year "draftees" equally well with one course, or would segregation of students with special interests into different groups improve training results for both?

The idea of special sections is neither original or new. The greatest difficulty lies in effecting the segregation, what with students' desires for particular instructors, particular times of day, and the imperfections of any identifying device to determine where a student should be placed. No special courses or separate sections were scheduled in 52 per cent of the schools. The experiment had been tried in another 8 per cent of the schools and the practice abandoned. On the other hand, special sections or courses are scheduled in 28 per cent of the schools, as follows: three different schools give a watered-down course for secretarial students, three different schools offer an introductory course for engineers, and one school each had sections for (a) two-year students, (b) liberal arts students, (c) pharmacy students, and (d) dietetics majors. Respondents tolerant of the special section idea mentioned other groups who might be served: law students, economics majors, pre-med students, prospective teachers, dental students, and agriculture majors. Only two schools reported more than one special section.

Asked to vote *pro* or *con* on the desirability of special sections or courses at the elementary level, 60 per cent of the respondents turned thumbs down; 36 per cent could see some benefit or advantage to be gained. Two-thirds of these indulgent respondents, however, stated that local circumstances would prevent scheduling special sections in their schools. The results are quite clear: This group of accounting educators doesn't care for special sections of first-year accounting or special elementary courses.

If the consensus of this group is typical, the elementary accounting course must be set up as an all-purpose course, designed to meet the needs of the nine students who will become accounting majors and the ninety-one who will labor in other fields. Our desire to keep the questionnaire short precluded an investigation of the changes in course content and presentation that were thought to be desirable, but it is fairly obvious that the course cannot be changed radically. Since accounting is a specialized statistical method of classifying quantitative data, and since the interpretation of those data is predicated on a body of knowledge, the student (whether he intends to be an accountant, banker, engineer, doctor, secretary, or beer dispenser) must get an understanding of the system of double-entry and the concept of income measurement on the accrual basis. He has to get the hang of the system. He can accomplish this only by coming to understand certain notions and conventions—both in the abstract and as applications to specific transactions—and by some repetition of the mechanical processes of sorting and filing data.

THE ACCOUNTING REQUIREMENT IN SCHOOLS OF BUSINESS ADMINISTRATION

The elementary course is a 6-hour course in 38 per cent of the schools, an 8-hour course in 58 per cent, and a 9-hour course in one school. There appears to be no convincing argument for an 8-hour course over a 6-hour course. Usually the number of lecture periods is the same, and the extra two hours are simply compensation for the heavy work-load imposed on stu-

dents of first-year accounting. No doubt, the precedent of the sciences was followed, but without quite as good rationalization. While the science student must of necessity do some or most of his work with apparatus unavailable except in laboratories, the accounting student needs no special paraphernalia or environment to work his problems. Whether a college student deserves semester hours for supervised study is a moot point.

Another possible explanation of the high incidence of an 8-hour elementary course may be the opinion that six hours is not adequate for the business student. Such was the express opinion of 72 per cent of the respondents in this survey; only 16 per cent considered six hours to be adequate. Again, the question raised is whether extra hours for laboratory work is warranted, or whether the extra hours should be in additional course work.

Rather than ask how many hours these accounting teachers thought *should* be required of all students, they were asked how many hours *could* be required in their individual schools, given the core courses already required and the existing balance of power in the several departments. Many schools already have a requirement in excess of six hours, but 72 per cent of the respondents indicated that more than six hours could be required in their schools, as against 12 per cent who said six hours was the ceiling for practical purposes. Only 20 per cent had the opinion that more than nine hours could be required, however, while 64 per cent thought it futile to try for more than nine hours. This brings us back to the alternatives: (1) an 8-hour elementary course, or (2) a 6-hour first-year course and one 3-hour intermediate course.

Of the group reached in this survey, 48 per cent preferred the 8-hour elementary course alternative, 40 per cent voted for the 6-hour elementary course plus three hours of intermediate, and 8 per cent wrote in a choice of an 8-hour elementary course plus a 3-hour course.

The consensus, it may be concluded, is that the accounting requirement for all business students should be increased and can be increased by one course in most schools now having a lower requirement than nine hours. The implication is that all business administration students need a course beyond the elementary year in order to round out their understanding of basic accounting processes and the conceptual framework which tends to make methods and analyses reasonable and uniform, and also to give them a familiarity with more advanced applications of accounting to decision-making and control of performance.

Some schools already have a requirement of accounting beyond the first-year course. Two schools (8 per cent) require six hours of intermediate of all students; five other schools require three hours of intermediate. Both of the schools requiring six hours of intermediate have a 6-hour elementary course; three of the five schools requiring three hours of intermediate also give a 6-hour elementary course. To sum up, three schools (a bare 12 per cent) require only six hours of accounting, ten require eight hours, five schools require nine hours; four require eleven hours, and two schools require twelve hours of all students in the division of business administration.

One school requires elementary cost as the intermediate course for all except general business majors; one school apparently requires a course relating to individual income tax. Courses taken most frequently as electives by non-accounting majors are elementary cost, the first intermediate course, and income tax, in that order. Not too much significance can be attached to this summary, however, since these are usually the only courses open to students just emerging from the elementary course.

THE REQUIRED INTERMEDIATE ACCOUNTING COURSE

Now, if a course beyond elementary is to be required of all business administration students, which of our present courses will best meet the bill of specifications, or is a new course called for? Respondents were equally divided on the question, "Do you think an intermediate course especially designed for non-accounting majors has merit?" Asked if they would consider offering such a course, 60 per cent said "No" and 40 per cent "Yes"; however, when the schools already requiring courses beyond elementary are excluded, 53 per cent answer in the affirmative.

Reasons given in support of negative answers are of some interest: 28 per cent cited the already crowded curriculum and the tightness of the required core of courses. Twelve per cent indicated physical limitations or administrative obstacles, such as lack of rooms, insufficient staff, or objection of the dean. One respondent thought cost should be the third-semester course. One could see no reason for a course different from the "regular" intermediate course.

Resistance to a proposition to increase the number of required hours is real, sound, and often formidable. Nevertheless, since the beginning of business administration as a separate division, school, or college, accounting has been acknowledged as the bulwark of the program. Typical of alumni opinion is the result of a local survey made recently, in which accounting was the subject most frequently named as valuable for the ex-student. Not infrequently the accounting department carries the professional school, much as football carries minor sports. It is safe to say that in most faculties the majority opinion would be favorable to a nine-hour requirement in accounting.

Some observe that there is no demand for such a course. Demand for a course still on the drawing board can hardly be expected to register heavily on the student applause meter. To some extent demand is a product of promotion. Though the academician professes to shrink at the thought of promoting a program or a course, the accounting profession has begun to face the facts that public relations can be carried on at a professional level and must be if the accountant is not to find his function pirated by other groups. It is a part of our duties both as professional accountants and teachers, to discover and train inductees into the profession and also to make potential users of accounting services more intelligent consumers.

Some representatives of small colleges state that it is difficult enough to offer one intermediate course, much less two. The answer is that if a specially designed course would better satisfy the needs of the majority of the students, it should be the one course offered rather than the traditional first course in intermediate accounting. Any loss to the accounting major could be made up in advanced courses up the line, and loss to the 9 per cent would be more than offset by the gain of the 91 per cent.

One respondent replied that his staff could not see how the proposed intermediate course would differ from the "regular" course. One objective of the survey was to ascertain opinions with respect to this point—scope of subject matter to be included in a special intermediate course and the relative emphasis to be placed on the several topics. A limited number of topics was listed on the questionnaire, and respondents were requested to indicate whether each topic should be (1) covered thoroughly, (2) treated in some detail, (3) touched upon, or (4) omitted altogether. The first three choices were weighted 5, 3, and 1 points, and the topics are ranked in order as follows:

Rank	*Topic*	*Treatment in "Regular" Course*
1st	Exposition of accepted principles and standards	Fair to good
2d	Analysis of orthodox financial statements	Piecemeal or adequately at the expense of assets
3d	Managerial uses of accounting data	Incidental and scanty
4th	Federal income tax for individuals	Practically ignored as such
5th	Partnership and corporation procedures	Corporations thorough
6th	Budgetary control and forecasting	Not covered
7th	Federal income tax for business entities	Spotty, as exceptions to accounting practice
8th	Principles of internal control and audit	Incidental to valuation
9th	Job-order cost accounting methods	None
10th	Systems design and accounting machines	Scanty
11th	Process cost accounting methods	None
12th	Functions of public accountants	Practically ignored
13th	Standard cost accounting methods	None

These findings point rather clearly to the areas thought to be of most use and significance to the non-accountant. First, no matter what use he is to make of accounting reports and data, the accounting point of view and the underlying rationale must be comprehended by the businessman. He must know the assumptions and self-imposed limitations reflected in accounting statements and reports. Secondly, it seems likely that analysis of published statements will be a concern of the business careerist; consequently, he should be given a working facility in computing and interpreting ratios and drawing inferences about liquidity, earning power, and balance from those relationships. Thirdly, the business administration student, it is presumed, will be engaged in commercial activity more intimately than as an investor. He needs to be aware of what accounting can do to assist him in performing his duties as a sales, production, distribution, or administration agent of enterprise. He must know what tools are available to him. Finally, since income tax affects practically all individuals, the least that we can do is to make it likely that the student will know what records to keep for tax purposes, how his individual tax liability is computed, and how the professional accountant can help him in minimizing his tax burden lawfully.

Our typical first course in intermediate accounting does not measure up too well against these specifications. While principles and concepts are presented, the orthodox course follows the balance-sheet order of items for discussion and rarely completes the asset side. The student, therefore, sees the relationship of concepts and applications in a very narrow range.

In some regular courses, analysis of financial statements is incidental and unintegrated. When it is emphasized and handled as an entity, coverage of assets is proportionately reduced. Regular intermediate texts are preoccupied with problems of income determination, or financial accounting, as opposed to managerial accounting.

The chapter on budgeting usually falls in the second intermediate course, or in the advanced course, and is often skipped because of the press of time. Individual income tax matters are rarely pointed up as such, except that computations applicable to both individuals and businesses are presented when they differ from orthodox financial accounting methods. Internal control is ordinarily discussed in connection with specific accounts. It is questionable that the student ever relates internal control of cash, say, with internal control of inventories and comes to appreciate the basic principles of internal control which are common to each application. Financial accounting for a manufacturing business is reviewed in the early part of the traditional course, but cost techniques are ignored.

The choice between a requirement that

all business students take the first typical course and the requirement of a course specially organized for non-accounting majors boils down to the choice between spading the garden as against hiring a man with a plow. Certainly there are arguments, and good ones, for pulverizing the soil to a depth of a foot or more, a handful at a time. If the gardener has the time and the muscle, he will prepare the soil better by spading. If his spare time is limited—and it usually is—he will generally do better to have his garden plot plowed and devote his time to planting and cultivating.

Apparently, the third semester is the last shot we have at students who have not chosen accounting as a major field. Those of us who propose a special course at the intermediate level think that we would thus serve the future banker, manager, statistician, or business owner better by giving him (1) a broader concept of the variety of accounting services available to him, (2) enough technique to insure his understanding of accounting reports, and (3) a positive feeling of a need for qualified accountants to assist him in doing his own work, rather than to give him an artisan's tool kit containing a very limited number of tools.

A MASTER SCHEDULE FOR PARTNERSHIP DISSOLUTION—INSTALLMENT BASIS

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The dissolution proceedings of a partnership may be simplified by preparing a schedule which *anticipates* cash distributions among partners. The usual academic presentation of material pertaining to partnerships and their dissolution considers the assets other than the cash installment available to the partners at that time to be a possible loss. The possible loss is apportioned among partners to ascertain the excess of the partners' investments over their individual shares of the possible loss. Then the cash installment is allocated among partners according to the excess of the investments over shares of the possible loss. In case some of the partners have investments which do not exceed their shares of the possible loss, the deficiency or deficiencies must be apportioned among the other partners in their profit and loss ratio to each other. This process is repeated for each cash installment which becomes available for distribution among the partners.

Only one schedule is necessary to ascertain the allocation of all cash installments in partnership dissolution on the installment basis. This schedule *anticipates* the allocation of cash among partners before dissolution proceedings are started. As an example, assume the *A*, *B*, *C*, *D* Partnership is to be dissolved. The partners have investments and share profits and losses as follows:

Partners	*Investments*	*Profit and Loss Ratio*
A	$90,000	6
B	$80,000	4
C	$75,000	3
D	$60,000	2

Since the ratio of investments and the profit and loss ratio are not equal, some partners will receive cash before other partners upon the dissolution of the business. After creditors have been paid from partnership funds, how would a cash installment of $5,000 be distributed among the partners? Then another installment of

SCHEDULE I
A, B, C, D—PARTNERSHIP
IN DISSOLUTION
SCHEDULE OF FUTURE CASH ALLOCATIONS

	A	*B*	*C*	*D*
(1) Investment Balances	$90,000	$80,000	$75,000	$60,000
(2) Profit and Loss Shares	6	4	3	2
(3) Relative Equities	$15,000	$20,000	$25,000	$30,000
(4) *Order* in Which Partners Will Share in Cash Installments	4	3	2	1
Investment Balances	$90,000	$80,000	$75,000	$60,000
(5) Limit of Cash Allocation to Partner *D* before Partner *C* Begins to Share				10,000
	$90,000	$80,000	$75,000	$50,000
(6) Limit of Cash Allocation between Partners *C* and *D* in Profit and Loss Ratio, 3:2, before Partner *B* Begins to share			15,000	10,000
	$90,000	$80,000	$60,000	$40,000
(7) Limit of Cash Allocation among Partners *B*, *C*, and *D* in Profit and Loss Ratio, 4:3:2, before Partner *A* Begins to Share		20,000	15,000	10,000
	$90,000	$60,000	$45,000	$30,000
Ratio of Investments	6	4	3	2
(8) All Subsequent Cash Allocations Made in Profit and Loss Ratio, 6:4:3:2	6	4	3	2

$5,000? And another installment of $10,000? According to the usual procedures, three separate schedules would be prepared to ascertain the equitable allocation of the cash installments. *A single master schedule* can be prepared which *anticipates* the *equitable* distribution of cash among partners *regardless* of the *amount* of any *one* installment *or* the *frequency* of installments. Schedule I is the master schedule prepared from the partners' investments and the profit and loss ratio assumed above.

The schedule may be used to answer the questions about the allocation of the successive installments of $5,000, $5,000, and $10,000. According to line (5) of Schedule I, the first installment of $5,000 would be given to Partner *D*. The second installment amounting to $5,000 would be given to Partner *D*, according to line (5), to achieve the limit of $10,000 to Partner *D* before Partner *C* begins to share. The third installment amounting to $10,000 would be distributed between Partners *C* and *D* in a 3:2 ratio, respectively, as shown on line (6) of Schedule I. These amounts would be $6,000 to Partner *C* and $4,000 to Partner *D*.

Schedule II proves the allocation of the first installment. The same type of schedule could be prepared to prove the other cash distributions.

PREPARATION OF THE SCHEDULE

The procedures to be followed in the preparation of a single master schedule are given below.

Step I

Ascertain the order in which partners will share in cash installments. As mentioned before, in case of a disparity between the ratio of investments and the profit and loss ratio, one partner will be allocated cash before other partners begin to share. The order in which partners will share is ascertained by comparing *relative equities*. Relative equity is the investment of a partner per unit share of profit and loss as contrasted to the other partners. Divide the investment of each partner by

SCHEDULE II

A, B, C, D—PARTNERSHIP

IN DISSOLUTION

SCHEDULE OF PROOF OF ALLOCATION OF INSTALLMENT OF FIVE THOUSAND DOLLARS

	Cash	Other Assets	Investment Balances *A*	*B*	*C*	*D*
Balances		$305,000	$90,000	$80,000	$75,000	$60,000
Asset Realization	$5,000	5,000				
	$5,000	$300,000	$90,000	$80,000	$75,000	$60,000
Possible Loss—6:4:3:2 Ratio		300,000	120,000	80,000	60,000	40,000
	$5,000		($30,000)		$15,000	$20,000
A's Deficiency—4:3:2 Ratio			30,000	$13,333	10,000	6,667
	$5,000			($13,333)	$ 5,000	$13,333
B's Deficiency—3:2 Ratio				13,333	8,000	5,333
	$5,000				$ 3,000	$ 8,000
C's Deficiency					3,000	3,000
Cash to Partner *D*	$5,000					$ 5,000

SCHEDULE III

	A	*B*	*C*	*D*
(1) Investment Balances	$90,000	$80,000	$75,000	$60,000
(2) Profit and Loss Ratio	6	4	3	2
(3) Relative Equities	$15,000	$20,000	$25,000	$30,000
(4) *Order* in Which Partners Will Share in Cash Allocations	4	3	2	1

his share of profits and losses, line (3) of the master schedule and Schedule III. The *size* of the relative equity determines the *order* in which partners will share in cash installments, line (4).

In case some of the partners have made loans to the partnership, the amount of the loan is added to the investment before the schedule is started and appears as a part of the investment in the schedule.

Step II

Ascertain the maximum amount or limit of cash to be allocated to the partner with the largest relative equity before the partner with the second largest relative equity begins to share. All references to the largest or first relative equity, second, third, and fourth are based on the comparisons or sizes of the relative equities computed in Step I or line (3) of the master schedule.

Largest Relative Equity (*D*, above)	$30,000
Second Largest Relative Equity (*C*, above)	25,000
Difference	$ 5,000
Multiply by Profit and Loss Share of Partner with Largest Relative Equity	2
Limit to be Allocated to *D* before *C* Begins to Share	$10,000

As this limit is allocated to *D*, the investments and relative equities will be as follows:

SCHEDULE IV

	A	*B*	*C*	*D*
Investment Balances	$90,000	$80,000	$75,000	$60,000
Allocation of First Limit to *D*				10,000
	$90,000	$80,000	$75,000	$50,000
Profit and Loss Ratio	6	4	3	2
Relative Equities	$15,000	$20,000	$25,000	$25,000

The relative equities are the keys to the allocation limits before additional partners share in cash allocations. When the profit and loss ratio equals the investment ratio for any number of partners, these particular partners will share in all subsequent cash installments in this ratio. Too, when these two ratios are equal, the relative equities are equal, as shown in Schedule IV for C and D. The ***limit*** to be allocated at any stage in the dissolution proceedings is based upon ***bringing the relative equities into agreement***. To reach the first limit, cash must be given to the first partner to reduce his relative equity to that of the second partner.

Step III

Ascertain the amount or limit of cash to be allocated to the two partners with the largest relative equities before the third partner begins to share. This is called the second limit, line (6) of the master schedule. To ascertain the second limit, the allocations to two partners must be computed, the limits to C and to D in the illustration. The limit to the second partner is computed as follows:

Second Largest Relative Equity (Partner *C*)	$25,000
Third Largest Relative Equity (Partner *B*)	20,000
Difference	$ 5,000
Multiply by Profit and Loss Share of Partner with Second Largest Relative Equity	3
Amount to *C* Before *B* Begins to Share	$15,000

The first partner or the partner with the largest relative equity also shares in the second limit. To compute the amount to the first partner in the second limit, solve the following equation:

$$\frac{\text{Amount to Second Partner to Share}}{\text{Profit Share of Second}} = \frac{\text{Amount to First Partner to Share}}{\text{Profit Share of First}}$$

$$\frac{\$15{,}000}{3} = \frac{\text{Amount}}{2}$$

$$\text{Amount} = \$10{,}000$$

Amount to First Partner in Second Limit	$10,000
Amount to Second Partner in Second Limit	15,000
Second Limit to First and Second Partners before Third Partner Begins to Share	$25,000

The cash which becomes available, after the first limit has been allocated to the first partner, will be allocated between the first and second partners in their profit and loss shares to each other, 3:2 in the illustration, until the limit is reached. After the second limit has been allocated, the relative equities will be as follows:

SCHEDULE V

	A	*B*	*C*	*D*
Investment Balances	$90,000	$80,000	$75,000	$50,000
Allocation to Second Limit			15,000	10,000
	$90,000	$80,000	$60,000	$40,000
Profit and Loss Ratio	6	4	3	2
Relative Equities	$15,000	$20,000	$20,000	$20,000

In reaching the second limit, cash must be allocated to the partners with the two largest relative equities, line (3) of the master schedule, to reduce their individual relative equities to that of the third partner.

Step IV

Ascertain the amount of cash to be allocated to the three partners with the largest relative equities before the fourth partner begins to share. This is the third limit, line (7) of the master schedule. To ascertain the third limit, the amounts to three partners must be computed. Given below is the computation of the first of the three amounts.

Third Largest Relative Equity (Partner *B*) . .	$20,000
Fourth Largest Relative Equity (Partner *A*).	15,000
Difference	$ 5,000
Multiply by Profit and Loss Share of Partner with Third Largest Relative Equity	4
Amount to *B* Before *A* Begins to Share	$20,000

For the maximum allocations to the first and second partners in the third limit, solve the following equation:

$$\frac{\text{Amount to Third, \$20,000}}{\text{Profit Share of Third, 4}} = \frac{\text{Amount to Second, ?}}{\text{Profit Share of Second, 3}} = \frac{\text{Amount to First, ?}}{\text{Profit Share of First, 2}}$$

Amount to First Partner in Third Limit	$10,000
Amount to Second Partner in Third Limit	15,000
Amount to Third Partner in Third Limit	20,000
Third Limit before Fourth Partner Begins to Share	$45,000

The cash should be allocated as it becomes available to the partners in their profit and loss shares to each other, 4:3:2 in the illustration, until the limit is reached in case less than $45,000 becomes available after the first two limits have been allocated. In the third limit, cash must be allocated to the partners with the three largest relative equities, line (3) of the master schedule, to reduce their relative equities to that of the fourth. After the allocation of the third limit, the relative equities will be as follows:

SCHEDULE VI

	A	*B*	*C*	*D*
Investment Balances	$90,000	$80,000	$60,000	$40,000
Allocation of Third Limit		20,000	15,000	10,000
	$90,000	$60,000	$45,000	$30,000
Profit and Loss Ratio	6	4	3	2
Relative Equities	$15,000	$15,000	$15,000	$15,000

The relative equities will be equal after the third limit has been allocated. The profit and loss ratio equals the ratio of investments, therefore all subsequent cash installments will be allocated in this ratio. Step IV would be repeated for successive partners in case there were more than four partners.

USE OF THE SCHEDULE

When using the schedule, the amount of previous allocations to partners must be considered. For example, assume that the following cash installments became available for distribution among the partners.

March 1	$ 9,000
June 1	$ 25,000
October 1	$136,000

March 1 Cash Allocation.

Cash to *D*, Line (5) of Master Schedule	$ 9,000

June 1 Cash Allocation.

	C	*D*	*Total*
Cash to *D*, Remainder of First Limit, Line (5) of Master Schedule		$ 1,000	$ 1,000
Cash to *C* and *D*, $24,000 in 3:2 Ratio, Line (6) of Master Schedule	$14,400	$ 9,600	24,000
Total	$14,400	$10,600	$25,000

October 1 Cash Allocation.

	A	*B*	*C*	*D*	*Total*
Remainder of Second Limit to *C* and *D* in 3:2 Ratio, Line (6) of Master Schedule			$ 600	$ 400	$ 1,000
Third Limit in 4:3:2 Ratio to *B*, *C*, and *D*, Line (7) of Master Schedule		$20,000	15,000	10,000	45,000
Remainder of Installment in 6:4:3:2 Ratio, Line (8) of Master Schedule	$36,000	24,000	18,000	12,000	90,000
Total	$36,000	$44,000	$33,600	$22,400	$136,000

Each limit can be proved by assuming that cash in the amount of the particular limit in succession becomes available for distribution among the partners. Each installment can be proved by a schedule comparable to Schedule II.

This single schedule, called a master schedule, may be used by accountants, lawyers, or anyone supervising the dissolution of a partnership in which the profit and loss ratio of the partners differs from the ratio of investments. If the ratios are equal, a schedule is not necessary, in that cash installments and profits and losses on realization and expenses of dissolution are allocated in this ratio. This is a schedule of *cash* allocations prepared either in advance or in the early stages of the dissolution. Profits or losses on realization and expenses of dissolution are allocated in the profit and loss ratio, therefore a schedule is not necessary for the apportionment of profits or losses. The mastery of the preparation and use of this schedule should save time and should provide all parties concerned with information as to exactly when particular partners will begin sharing in cash installments.

PROFESSIONAL EXAMINATIONS

A Department for Students of Accounting

HENRY T. CHAMBERLAIN

THE FOLLOWING problems were prepared by the Board of Examiners of the American Institute of Accountants, and were presented as the first half of the C.P.A. Examination in Accounting Practice on May 3, 1954. The candidates were required to solve problems 1, 2 and 3 and either problem 4 or problem 5. The total weight assigned to this section of the examination was 50 points. Weights were not assigned to the individual problems but a suggested time for each problem was given. The examiners point out that the suggested time allowances are closely proportional to the point values of the various problems. The estimated time is given below:

Problem 1	60 to 90 minutes
Problem 2	35 to 50 minutes
Problem 3	40 to 65 minutes
Problem 4 or Problem 5	40 to 65 minutes

No. 1

The Bloom Florist Shops are owned and operated by Sumner Bloom in two separate locations. Mr. Bloom has called you in for assistance. He states that until two years ago he operated only a small card and flower shop in an adjoining town. At that time he opened a new and modern shop in the city and affiliated with the Florists Telegraph Delivery Association.

Although he has had large gains in sales and profits in these last two years, Mr. Bloom has never effected any substantial improvement in his financial condition. He has looked into the problem from the personnel and physical standpoints and is satisfied with the honesty of the employees and the conformity of his product, service, and price with that of other florists. He asks that you look over the profit statement prepared for the prior fiscal year. *It is his intention that this should be on a cash basis.*

Your initial inquiries develop the following facts:

Each store makes a daily report of certain financial and other data to the administrative office. This report includes, but is not limited to, the following information: opening cash balance, cash sales, charge sales, cash received on account, amounts paid out, amounts deposited, and ending cash balance. In addition, the retail values of inbound and outbound F.T.D. transactions are listed.

(FTD is an association of florists providing florists' services in other cities and towns. The florist with whom the customer places an order retains 20% of the retail value of the order, 80% being credited to the florist in the city where the order is filled and delivery made. The remittance is not made directly, since all of these transactions are channeled through a central clearing house operated by FTD. Member florists receive a monthly statement showing inbound and outbound items, as well as service and advertising charges. A net credit balance is accompanied by a remittance from FTD; a net debit balance is paid by the florist to FTD.)

All disbursements by Bloom's shops, except for minor expenses shown on daily reports, are paid by check at the office.

No journals or ledgers are kept. Income statements have been prepared by the "bookkeeper" by summarizing on columnar paper certain of the data provided on the daily reports and from the checkbook stubs.

Following is the income statement so prepared for the fiscal year ended July 31, 1954:

BLOOM FLORIST SHOPS
Income Statement
Year Ended July 31, 1954

RECEIPTS	
Cash Sales	$100,000
Charge sales	120,000
Inbound FTD orders received	25,000
20% of outbound FTD orders sent	3,000
Miscellaneous	2,000
Total receipts	$250,000
EXPENSES	
Purchases, flowers	$ 80,000
Purchases, other merchandise	5,000
Salaries and wages	75,000
Rent	7,200
Express and freight	7,000
Utilities	2,000
Telephone and telegraph	3,000
Delivery expense and repairs	5,500
Repairs and maintenance	3,000
Advertising	2,500
Discounts and refunds	2,000
Depreciation and amortization	2,500
FTD discount on orders received	5,000
Payments to FTD	4,000
Interest	1,500
Miscellaneous	4,000
Total expenses	$209,200
NET PROFIT	$ 40,800

The following additional accounting information is assembled by you:

(1)	Miscellaneous receipts include:	
	Refunds and freight claims	$ 200
	Insurance proceeds reimbursing repair costs of delivery truck involved in accident	600
	Federal income tax refund—1951	300
	Sale of fully depreciated assets	700
	Other items	200
		$ 2,000
(2)	Miscellaneous expenses include:	
	Donations	$ 1,200
	Dues and subscriptions	800
	Taxes and licenses	500
	Insurance	800
	Bad accounts considered uncollectible	500
	Cash over	200
		$ 4,000

(3) Cash payments to FTD for the fiscal year were $ 4,000

(4) Cash receipts from FTD for the fiscal year were $ 7,500

(5) FTD charges for advertising and expense (included in advertising expense on the income statement $ 1,500

(6) Depreciation on delivery equipment is on a four-year basis. Included in the depreciation taken is $250.00 for a station wagon, purchased February, 1954. You find that $2,000 was paid in cash in addition to a trade-in of $1,200 allowed for a family sedan which had not been used in the business. Mr. Bloom anticipates that 75% of the station wagon usage is attributable to the business.

(7) Cash received on account $115,000

(8) Inventories are not material and the estimated difference between the opening and closing balance is only $100.

(9) Cash and charge sales include amounts received from customers on outbound FTD orders.

You are required to:

a. Prepare a worksheet showing adjustments to the income statement to reflect the results of Bloom's operation for the past fiscal year on the cash basis.

b. Give explanations for each adjustment, showing calculations where appropriate. Key the explanations to the adjustments in the worksheet.

c. Cite the more important advantages to be gained by Bloom in the installation of a simple set of books, using

the facts in the problem as illustrations where possible. You need not specify the books or other records to be maintained.

No. 2

William Boyce, whose fiscal year for accounting and Federal income taxation purposes ends on March 31 each year, holds common stock of the Ives Corporation. A summary of transactions concerning these holdings is given below. (Several cash dividend transactions are omitted, and the problem requirements relate only to the data given.) Mr. Boyce uses the specific identification method in accounting for his stock transactions.

Prepare a schedule (or schedules) showing clearly the computation of:

a. The remaining cost of Ives Corporation common shares held by Mr. Boyce on March 31, 1954.
b. The *total* of dividend income from date of acquisition of the first block of shares through March 31, 1954 that should be:
   (1) Reported for financial accounting purposes.
   (2) Reported for Federal income taxation purposes.
c. The gain or loss on sales made of Ives Corporation securities that should be:
   (1) Reported for financial accounting purposes.
   (2) Reported for Federal income taxation purposes.

Label all supporting computations clearly.

TRANSACTIONS

6/12/47	Purchased 50 shares of Ives common ($100 par) at a total cost of $4,600.
12/15/47	Paid assessment of $5 per share to Ives Corporation.
4/15/50	Converted 50 shares of Ives preferred into the same number of common shares in accordance with conversion privilege. The preferred shares had cost $4,900 and their market value was $96 per share. Market value of common was $101 at that time.
11/2/51	Received cash dividend of $.50 per share on Ives common.
5/7/52	Received additional shares of Ives common in a 2-for-1 stock split. (Par value reduced to $50.)
6/2/52	Purchased 100 shares of Ives common at a total cost of $5,300.
11/4/52	Exercised option to receive one share of common for each 10 shares held in lieu of a cash dividend of $5.40 per share held. The fair market value of a share was $54.
11/2/53	Received ordinary stock dividend equal to 20% of common shares held.
1/4/54	Received warrants representing right to purchase at par 1 share of Ives common for each 10 shares of common held. On date of issue of warrants, market price of shares "ex-rights" was $58 and of rights, $2.
1/15/54	Exercised the 100 "rights" applicable to the block of shares purchased on 6/2/52 and sold all remaining "rights." Net proceeds from sale of rights amounted to $1.80 per right.
3/12/54	Sold 60 shares of Ives common for $3,240 net proceeds. Shares were identified as 50 of those purchased on 6/2/52 and 10 purchased on 1/15/54.

No. 3

The A B C Lumber Company was organized in 1934. At that time it purchased the timber land it now owns. During the years since 1934 it has bought finished lumber from a nearby mill and sold to the retail trade. It files calendar year income tax returns and computes its inventories at the lower of cost or market. In July, 1953, the company decided to expand its operations and to use its timber in the business. It will grow its timber, manufacture it into lumber, and sell to the retail trade. Construction of a sawmill was begun immediately and, on January 2, 1954, logging and manufacturing operations were started.

At January 1, 1954, its timber land acquired in 1934 consisted of 15,000 acres of land on which were 30,000,000 log feet of merchantable timber. The original purchase price was $240,000.00. Approximately 60% of the timber was pine and the balance gum. Cutover lands in these localities were worth approximately $3.00 per acre at date of acquisition.

The company at 12/31/54 elects to be governed by the provisions of Sec. *631(a) IRC* and related regulations, summarized in part as follows:

If the taxpayer so elects upon his return for a taxable year, the cutting of timber

(for sale or for use in the taxpayer's trade or business) during such year by the taxpayer who owns such timber (providing he has owned such timber for a period of more than six months prior to the beginning of such year) shall be considered as a sale or exchange of such timber cut during such year. In case such election has been made, gain or loss to the taxpayer shall be recognized in an amount equal to the difference between the adjusted basis for depletion of such timber in the hands of the taxpayer and the fair market value of such timber. Such fair market value shall be the fair market value as of the first day of the taxable year in which such timber is cut, and shall thereafter be considered as the cost of such cut timber to the taxpayer for all purposes for which such cost is a necessary factor. ("Cost" applicable in determining the amount of inventories of cut timber and of products of timber cut shall include the fair market value of the timber cut, the cost of cutting, logging and all other expenses incident to converting the standing timber into the products in inventory.) However, in valuing inventories, the taxpayer may use the lower of cost or market if that is the basis used by him.

The 1954 expenses of cutting and logging were $20.00 per thousand feet and expenses of manufacturing were $18.00 per thousand, exclusive of depletion. The following additional information is available

	Lumber Manufactured in 1954	*Fair Market Value of Standing Timber 1/1/54*	*Fair Market Value of Standing Timber 12/31/54*	*Inventory—12/31/54*	
				Manufactured Lumber	*Logs*
Pine	3,000,000 ft.	$45.00 per M	$42.00 per M	1,000,000 ft.	50,000 ft.
Gum	500,000 ft.	30.00 per M	28.00 per M	200,000 ft.	10,000 ft.

For purposes of this problem, assume that log feet produced equal amounts of board feet and disregard other gains or losses. In computing depletion, disregard the difference in relative values of types of timber cut—use general average per thousand feet for the tract during that year.

a. You are to compute at 12/31/54 the capital gain on the cutting of timber.
b. You are to compute the valuation of the ending inventories for balance sheet presentation at 12/31/54 as well as for Federal income tax purposes.
c. You are to discuss the valuation problems presented in this company.

No. 4

At December 31, 1953 the balance sheet of Company A was as follows:

Cash	$ 50,000	Payables	$ 1,750,000
Receivables, less reserves	300,000	Accruals	450,000
Inventories	1,600,000	Common stock, 10,000 shares	1,000,000
Prepayments	47,000	Retained earnings	800,000
Fixed assets, less reserves	2,003,000		
	$ 4,000,000		$ 4,000,000

An appraisal as at that date, which was carefully considered and approved by the boards of directors of Company A and Company B, placed a total replacement value, less sustained depreciation, of $3,203,000 on the fixed assets of Company A.

Company B's condensed balance sheet at December 31, 1953 showed:

Cash and investments (including stock of A)	$ 7,000,000	Payables	$ 7,872,000
Receivables, less reserves	2,400,000	Accruals	1,615,000
Inventories	11,200,000	Common stock, 100,000 shares	10,000,000
Prepayments	422,000	Retained earnings	20,513,000
Fixed assets, less reserves	18,978,000		
	$40,000,000		$40,000,000

Company B offered to purchase all the assets of Company A, subject to its liabilities, as at December 31, 1953, for $3,000,000. However, 40% of the stockholders of Company A objected to the price on the ground that it did not include any consideration for goodwill, which they believed to be worth at least $500,000. A counter-proposal was made and final agreement was reached on the basis that Company B acquired 60% of the common stock of Company A at a price of $300 a share.

Prepare a consolidating statement as at December 31, 1953, of the two companies.

No. 5

The H. G. Company uses a standard cost system in accounting for the cost of one of its products.

The standard is based on budgeted monthly production of 100 units per day for the usual 22 work days per month. Standard cost per unit for direct labor is 16 hours at $1.50 per hour. Standard cost for overhead was set as follows:

Fixed overhead per month	$29,040
Variable overhead per month	39,600
Total budgeted overhead	$68,640
Expected direct labor cost	$52,800
Overhead rate per dollar of labor	$ 1.30
Standard overhead per unit	$ 31.20

During the month of September the plant operated only 20 days. Cost for the 2,080 units produced were:

Direct labor, 32,860 hours @ $1.52 =	$49,947.20
Fixed overhead	29,300.00
Variable overhead	39,065.00
	68365

You are required to:

a. Compute the variance from standard in September for (1) direct labor cost, and (2) overhead.
b. Analyze the variances from standard into identifiable causes for (1) direct labor, and (2) for fixed and variable overhead.

Solution to Problem 1

(a)

BLOOM FLORIST SHOPS
Work Sheet—Correction of Reported Income
Year Ended July 31, 1954

	Statement per Bookkeeper	Adjustments Dr.		Adjustments Cr.		Corrected Statement
RECEIPTS						
Cash sales	$100,000					$100,000
Charges sales	120,000	(9)	$120,000			
Inbound FTD orders received	25,000	(9)	25,000			
20% of outbound FTD orders sent	3,000	(9)	3,000			
Miscellaneous	2,000	(1)	2,000			
Refunds and freight claims		(10)	200	(1)	$ 200	
Insurance proceeds—delivery truck accident		(10)	600	(1)	600	
Federal income tax refund—1951				(1)	300	300
Sale of fully depreciated assets				(1)	700	700
Other items				(4)	200	
				(1)	200	400
Receipts from FTD				(5)	7,500	7,500
Receipts on account				(8)	115,000	115,000
	$250,000					$223,900

EXPENSES						
Purchases, flowers	$ 80,000					$ 80,000
Purchases, other merchandise	5,000					5,000
Salaries and wages	75,000					75,000
Rent	7,200					7,200
Express and freight	7,000			(10)	200	6,800
Utilities	2,000					2,000
Telephone and telegraph	3,000					3,000
Delivery expense and repairs	5,500			(10)	600	4,900
Repairs and maintenance	3,000					3,000
Advertising	2,500			(6)	1,500	1,000
Discounts and refunds	2,000					2,000
Depreciation and amortization	2,500	(7)	50			2,550
FTD discount on orders received	5,000			(9)	5,000	
Payments to FTD	4,000					4,000
Interest	1,500					1,500
Miscellaneous	4,000			(2)	4,000	
Donations		(2)	1,200			1,200
Dues and subscriptions		(2)	800			800
Taxes and licenses		(2)	500			500
Insurance		(2)	800			800
Bad accounts considered uncollectible		(2)	500	(3)	500	
Cash over		(2)	200	(4)	200	
	$209,200					$201,250
Net income—cash basis	$ 40,800					$ 22,650

Explanations

(b)

(1) To reclassify miscellaneous receipts.
(2) To reclassify miscellaneous expenses.
(3) To eliminate the charge for bad accounts from the cash basis statement.
(4) To eliminate "cash over" from expenses and to add this amount to receipts.
(5) To record receipts from FTD.
(6) To eliminate $1500 from advertising expense as this amount is reflected in net receipts from FTD.
(7) To correct depreciation on delivery equipment:

Cost	$3,200
Personal use—25%	800
Basis for business use	$2,400
Depreciation for current year: ½ (25% of $2,400)	$ 300
Depreciation taken	250
Adjustment	$ 50

(8) To record collection of charge sales.
(9) To eliminate non-cash items from receipts and expenses.
(10) To reclassify items as expense reductions.

(c)

The absence of a simple set of double-entry books kept by a person with a basic knowledge of accounting is the reason for the confusion and the errors in the reports going to Mr. Bloom. The statements are prepared from memoranda of various kinds and the "balancing" check provided by double-entry books is lacking. Such errors as the inclusion of "cash over" as an expense and duplicate charges for FTD advertising would be avoided with proper books. Also the installation of a set of books would require the employment of a bookkeeper other than the person now masquerading as such. Apparently the person now in charge of the accounts has no understanding of either the cash or accrual basis of accounting.

Solution to Problem 2

WILLIAM BOYCE
Schedule of Stock Transactions—Ives Corporation
June 12, 1947 to March 12, 1954

		Stock Acquired 6-12-47		Stock Acquired 4-15-50		Stock Acquired 6-2-52		Stock Acquired 11-4-52		Stock Acquired 1-15-54		Income for financial accounting and Federal tax purposes	
Date	*Explanation*	*No. Shares*	*Cost*	*No. Shares*	*Cost*	*No. Shares*	*Cost*	*No. Shares*	*Cost*	*No. Shares*	*Cost*	*Character of Income*	*Amount*
6-12-47	50 shares common purchased..........	50	$4,600.00										
12-15-47	Assessment $5/share.................		250.00										
4-15-50	Conversion 50 shares preferred to 50 shares common on conversion privilege			50	$4,900.00							None recognized	
11- 2-50	Dividend $.50 share.................											Dividend	$ 50.00
5- 7-52	Stock split 2 to 1 (Par value reduced to $50)...........................	50		50									
6- 2-52	Purchased 100 shares................					100	$5,300.00						
11- 4-52	Exercise option to take 1 share for each 10 in lieu of cash dividend of $5.40 per share.........................							30	$1,620.00			Dividend	1,620.00
11- 2-53	Stock dividend of 20%...............	20		20		20		6					
1- 4-54	Receipt of warrants to purchase 1 sh. common for each 10 shares held....												
1-15-54	Exercise of 100 rights (Schedule A)....									10	$647.22	None recognized	
	Sale of remaining rights (Schedule A)..		(161.67)		(163.33)		(176.67)		(54.00)			Long term capital gain	124.35
		120	$4,688.33	120	$4,736.67	120	$5,123.33	36	$5,166.00	10	$647,22		
3-12-54	Sales of 60 shs. common.............. 50 shs. purchased 6-2-52............ 10 shs. purchased 1-15-54........... (Schedule B)					(50)	(2,134.72)					Long term capital gain	565.28
										(10)	(647.22)	Short term capital loss	(107.22)
Balance of stock at 3-31-54	....	120	$4,688.33	120	$4,736.67	70	$2,988.61	36	$1,566.00	-0-	-0-		

SCHEDULE A—Cost of stock acquired on exercise of rights and gain on the sale of rights

Stock	No. of Rights	Allocation of Cost to Rights	Basis of Rights
6-12-47	120	$4850\times\frac{240}{7200}$	$161.67
4-15-50	120	$4900\times\frac{240}{7200}$	163.33
6-2-52	120	$5900\times\frac{240}{7200}$	176.67
11-4-52	36	$1566\times\frac{72}{2120}$	54.00
	396		$555.67
	100 rights exercised (1)		147.22
	296 rights sold		$408.45

(1) $\frac{100}{120}\times 176.67 = 147.22$

Proceeds from sale of 296 rights @$1.80 each		$ 532.80
Basis of rights		408.45
Gain (Long term capital gain)		$ 124.35
Cost of stock acquired on exercise of rights—		
Basis of 100 rights above	$147.22	
Cost of 10 shares @ $50	500.00	
	$647.22	

SCHEDULE B—Gain on sale of stock on 3-12-54

Sales price of 50 shares	$2,700.00
Basis of 50 shares acquired 6-2-52 50/120×$5,123.33	2,134.72
Gain (Long term capital gain)	$ 565.28
Sales price of 10 shares	$ 540.00
Basis of 10 shares acquired 1-15-54	647.22
Loss (Short term capital loss)	$ (107.22)

Solution to Problem 3

ABC LUMBER COMPANY

Inventory and Capital Gain Computation

Year Ended December 31, 1954

(a) *Computation of capital gain on cutting timber:*

	Per M Feet			
	Pine		*Gum*	
Lumber manufactured and logged		$ 3,050.00		$ 510.00
At fair market value January 1, 1954	$45.00		$ 30.00	
Less, adjusted cost basis (depletion)	6.50	38.50	6.50	23.50
Capital gain		$117,425.00		$ 11,985.00
		11,985.00		
Total capital gain		$129,410.00		

Note: Depletion cost as follows:			
Cost of land			$240,000.00
Recovery value			45,000.00
Net timber costs for 30,000 M feet			$195,000.00
Depletion per 1,000 feet			$ 6.50

(b) *Computation of inventories at December 31, 1954:* *Costs per thousand feet*	*Manufactured*	*Logs*	*Total*
Cost of cutting	$ 20.00	$ 20.00	
Manufacturing	18.00		
Depletion	6.50	6.50	
Total cost per thousand	$ 44.50	$ 26.50	
Thousand feet at December 31, 1954	1,200	60	
Total for financial accounting purposes	$ 53,400.00	$ 1,590.00	$ 54,990.00
Add:			
Depletion differences			
Pine—1,050 M ft. @ $38.50	$ 40,425.00		$ 40,425.00
Gum—210 M ft. @ $23.50		$ 4,935.00	4,935.00
Total for Federal tax purposes	$ 93,825.00	$ 6,525.00	$100,350.00

This problem presents a situation in which the concepts of "cost" for financial accounting and tax accounting purposes are at considerable variance. It is important in the financial statements that this variance be disclosed. Perhaps the disclosure can best be handled in a footnote keyed to the tax provision for the year.

The company values its inventories at the lower of cost or market values for both financial and tax accounting. For financial accounting purposes the cost of depletion is $6.50 per thousand feet—for tax purposes the depletion "cost" is considerably higher. There may be a temptation to lower the value of the inventories for tax purposes due to the drop in market value of standing timber but in the above solution this was not done because standing timber is only one element of the cost of the inventories of manufactured goods and logs. Because the information on market values is insufficient the inventories for tax purposes are valued at cost.

All indications in the problem are that cost for financial accounting purposes is less than market, therefore cost was used in the valuation of the inventories for statement purposes.

Solution to Problem 4

COMPANY B AND SUBSIDIARY
CONSOLIDATING BALANCE SHEET
DECEMBER 31, 1953

	Company B	*Company A*	*Eliminations Dr.*	*Eliminations Cr.*	*Consolidated Balance Sheet*
ASSETS					
Cash	$ 5,200,000	$ 50,000			$ 5,250,000
Receivables, less reserves	2,400,000	300,000			2,700,000
Inventories	11,200,000	1,600,000			12,800,000
Prepayments	422,000	47,000			469,000
Fixed assets, less reserves (including the excess of the cost of the investment in Company A over the book value of the stock acquired, $720,000, which excess is attributed to fixed assets of Company A)	18,978,000	2,003,000	$ 720,000		21,701,000
Investments in Company A—60%	1,800,000			$1,800,000	
	$40,000,000	$4,000,000			$42,920,000

LIABILITIES AND CAPITAL						
Payables	$ 7,872,000	$1,750,000			$ 9,622,000	
Accruals	1,615,000	450,000			2,065,000	
Common stock:						
Company B	10,000,000				10,000,000	
Company A		1,000,000	$ 600,000		400,000	Minority interest
Retained earnings:						
Company B	20,513,000				20,513,000	
Company A		800,000	480,000		320,000	Minority interest
	$40,000,000	$4,000,000	$1,800,000	$1,800,000	$42,920,000	

Solution to Problem 5

DIRECT LABOR

Actual cost of 2,080 units		$49,947.20
Standard cost of 2,080 units (2,080×$24.00)		49,920.00
Variance from standard—Unfavorable		$ 27.20
The variance is analyzed as follows:		
Rate variance:		
32,860 hours @ .02 per hour—Unfavorable		$ 657.20
Time variance:		
Units actually produced	2,080	
Units that should have been produced at standard time (32,860÷16)	2,053.75	
Excess units produced	26.25	
26.25 units @ $24.00—Favorable		630.00
Unfavorable variance—total		$ 27.20

FIXED OVERHEAD

Actual cost of 2,080 units		$29,300.00
Standard cost of 2,080 units @ $13.20		27,456.00
Variance from standard—Unfavorable		$ 1,844.00
The variance is analyzed as follows:		
Unused capacity:		
120 units @$13.20—Unfavorable		$ 1,584.00
Rate variance:		
Actual rate—$29,300.00÷2,200	$13.3181818	
Standard rate—$29,040÷2,200	13.20	
Excess	.1181818	
.1181818×2,200—Unfavorable		260.00
		$ 1,844.00

VARIABLE OVERHEAD

Actual cost of 2,080 units		$39,065.00
Standard cost of 2,080 units @ $18.00		37,440.00
Variance from standard—Unfavorable		$ 1,625.00
The variance is analyzed as follows:		
Rate variance:		
Actual rate ($39,065÷2,080)	18.78123	
Standard rate ($39,600÷2,200)	18.00000	
Excess	.78123	
Unfavorable variance—.78123×2,080		$ 1,625.00

ASSOCIATION NOTES

E. BURL AUSTIN

AUSTRALIA

University of Melbourne:

The first Chair of Accountancy in an Australian university has recently been set up as a memorial to the late Professor G. L. WOOD. A. A. FITZGERALD has been appointed the first occupant of the chair. He has been teaching accountancy at the University since 1925. He will retain association with his firm Fitzgerald and Thompson, of which he is senior member.

CANADA

Queens University:

New additions to the staff include E. J. BENSON as assistant professor and J. B. GALVIN as assistant to the director of professional courses. Galvin is a chartered accountant (Scotland).

DISTRICT OF COLUMBIA

The 4th Symposium of the Federal Government Accountants Association was held in Washington in November and featured discussion of the relation of the accountant and auditor to the procurement program.

ALABAMA

University of Alabama:

S. PAUL GARNER has been appointed acting dean of the School of Commerce.

A. J. PENZ has been appointed assistant head of the Accounting Department.

JOSEPH E. LANE is on leave for one year to complete his law degree.

DONALD MILLS has been appointed instructor, and ARCH STOCKARD has been appointed assistant professor.

CALIFORNIA

University of Southern California:

F. W. WOODBRIDGE has retired after more than twenty-five years as head of the Department of Accounting. WALTER B. MEIGS has been appointed in his place.

New appointments include LESLIE R. LOSCHEN as assistant professor and FOSTER W. JAMES as lecturer.

ROBERT DINMAN has resigned to accept a post at the University of Florida.

CARL DEVINE recently addressed a joint meeting of the Controller's Institute, Internal Auditors, Petroleum Accountants, and other groups, on the topic "Loss Recognition—Required Evidence."

WALTER B. MEIGS participated in the 6th Annual Graduate Study Conference at Claremont College in August.

University of San Francisco:

GEORGE L. MOSS has joined the staff as assistant professor replacing KENNETH FOOTE.

Recent appointments for the evening division include JOSEPH SIMINI and NICHOLAS PREPOUSES.

KENNETH YOUNG spoke recently before the San Francisco Society of CPA's on the new tax law provisions regarding depreciation.

Los Angeles State College:

MARY E. MURPHY represented the American Accounting Association at the Centenary of the Institute of Chartered Accountants in the summer of 1954 in Edinburgh, Scotland. She was later a guest at the presentation of the award for outstanding annual accounts at Tallow Chandler's Hall in the City of London. On a tour of British Universities she advised on curricular and teaching methods and offered seminars in research in accounting history and dilemmas in modern practice at the Incorporated Accountants' Hall.

COLORADO

University of Denver:

The 4th Annual Tax Institute was held in October with the co-sponsorship of the Colorado Society of CPA's and the city and state bar associations. Speakers included outstanding national and local tax men, CPA's, and lawyers.

GEORGIA

Emory University:

WALTER P. KENNON has been appointed as assistant professor in charge of advanced courses in the master's degree program.

L. E. CAMPBELL attended the meeting of State CPA Society Secretaries in New York in August.

IDAHO

University of Idaho:

L. P. VIDGER has been appointed visiting assistant professor.

CARL L. NELSON, professor of accounting at

the University of Minnesota, was visiting professor for a public utilities executives course in the summer.

HOWARD G. JENSEN has been granted a sabbatical leave to do graduate study at the University of Minnesota.

ILLINOIS

University of Chicago:

The University was host in October to the 7th Annual Federal Tax Conference which featured outstanding speakers from all over the country.

University of Illinois:

G. E. LUKAS has returned to the staff as assistant professor after spending nineteen years with the federal government. His most recent appointment was in the foreign service in New Dehli, India.

G. D. BRIGHTON has returned to the staff as assistant professor after spending a year with a national firm of public accountants.

R. K. MAUTZ has been promoted to the rank of professor.

M. K. KELLOGG, H. P. HOLZER, and R. E. SCHLOSSER have been promoted to the rank of instructor.

C. J. GAA is on leave of absence to serve as director of the newly established advanced training center, Internal Revenue Service.

R. I. DICKEY has been reappointed editor of the *Illinois Certified Public Accountant.*

NORTON M. BEDFORD was named chairman of the accounting section of the 1955 Midwest Economics Conference.

A group of nine leading accountants from Formosa are attending the University to receive a special course in accounting.

C. A. MOYER spent the month of July in Aruba, Netherlands West Indies, conducting two seminar courses for employees of the Lago Oil Company.

INDIANA

Indiana University:

L. E. HAY has been added to the staff as assistant professor to replace GEORGE E. NUNN.

RALPH D. SWICK is now an associate professor.

DAVID W. THOMPSON is currently on leave of absence working as a consultant with the General Electric Company.

IOWA

University of Iowa:

WILLIAM J. BURNEY has been promoted to the rank of professor.

The University, in cooperation with the Iowa Society of CPA's, recently conducted an accounting and tax conference in Iowa City.

KANSAS

Wichita University:

WILLIAM F. CRUM spoke on recent developments in accounting before a recent meeting of Instructors in Business and Commerce Subjects of Four-year Colleges in Kansas.

FRANCIS D. JABARA passed the Kansas CPA examination in May.

LOUISIANA

Louisiana State University:

LLOYD F. MORRISON spoke before the New Orleans Chapter of the Institute of Internal Auditors on the Subject "An Outsider Looks at Internal Auditing."

ELZY McCOLLOUGH is director of education of the Baton Rouge Chapter of NACA.

DANIEL FELLERS, on leave from Southwestern Louisiana Institute, is assisting with accounting instruction while working on his Ph.D. in accounting.

MASSACHUSETTS

Boston College:

RAYMOND DE ROOVER, formerly of Wells College, has joined the staff as professor of economics.

MICHIGAN

University of Michigan:

The University was host in October to the 29th Annual Michigan Accounting Conference co-sponsored by the Michigan Association of CPA's.

Wayne University:

T. R. LARIMORE was recently elected vice-president and director of education of the Detroit Chapter of the Federal Government Accountants Association. He teaches accounting courses in the evening program at the college.

University of Detroit:

C. G. SCHOEFFLER is on leave of absence to work on the doctorate at the University of Illinois.

V. E. FENELON and R. R. HASTINGS have been added to the accounting staff

MISSOURI

St. Louis University:

New staff members include ROY W. RICHARDS, formerly with Indiana University, and JAMES

O. EATON, formerly with Public Administration Service, both appointed assistant professor.

University of Missouri:

L. J. BENNINGER has been promoted to the rank of professor.

DONALD L. RICHARD has been appointed assistant professor.

L. J. BENNINGER spoke at the October meeting of the Tri-state Chapter, NACA, on the meaning of cost control in the small-size organization.

NEBRASKA

Creighton University:

JOHN P. BEGLEY has been reappointed to the Board of Examiners of CPA's for Nebraska; he has already served twelve years on the Board.

NEW HAMPSHIRE

Dartmouth College:

LEONARD E. MORRISSEY, a member of the Accounting Department, was presented the Elijah Watt Sells Gold Medal on October 19 at the annual meeting of the American Institute of Accountants in New York. He scored highest in a field of 9,879 who took the CPA examination last May. In addition to his teaching, he is associated with a firm of CPA's in Norwich, Vermont.

NEW YORK

Long Island University:

The following members of the department have been selected to serve on various committees of the New York State Society of CPA's: JOSEPH H. DWORETSKY, state tax committee; HYMAN R. GOLDBERG, membership committee; SAMUEL SPEYER, committee on foreign trade accounting; OSCAR J. SUFRIN, committee on meetings; and LEO SCHLOSS, chairman of committee on members in the field of education.

New York University:

MICHAEL SCHIFF lectured before the graduate school of sales management sponsored by the National Sales Executives conducted on the Campus of Rutgers University in August.

Niagara University:

Recent appointments as instructor include HAROLD C. BROWN and HENRY GRABON.

The University was host in October to the fall meeting of the New York State Association of Colleges of Business Administration.

OHIO

Ohio State University:

GEORGE D. BAILEY has been elected chairman of the Board of Nominations for the Accounting Hall of Fame. The Board has been reorganized for the coming year with forty-five members, fifteen of which come from each of three fields: public accounting, industrial and government accounting, and education.

LAUREN F. BRUSH, formerly of Syracuse University, has been appointed assistant professor.

THOMAS R. PICKRELL has been appointed instructor,

ROBERT D. HAY has resigned his instructorship after completing the Doctor of Philosophy degree and has returned to his teaching post at the University of Arkansas.

PAUL E. FERTIG is on leave of absence serving with the Department of Education of the American Institute of Accountants.

JAMES R. MCCOY has been elected vice-president of the Columbus Chapter of NACA. He is also editor of the *Ohio Certified Public Accountant.*

HORACE W. DOMIGAN is a director of the Ohio Society of CPA's and is serving as its secretary-treasurer.

WILLIAM B. JENKS has been named a member of the Grand Council of the Beta Alpha Psi fraternity.

RUSSELL S. WILLCOX died July 29, 1954, after thirty years as a member of the staff.

University of Dayton:

ROBERT P. BEHLING and JOHN M. PERDUE have been appointed instructor in accounting.

K. LAURENCE CHANG has been promoted to assistant professor.

D. B. SPRINGER has left to devote full time to public accounting practice.

LAURENCE CHANG was moderator of the Institute on Federal Taxation held on the campus for three days in October. The Institute was attended by seventy-seven accountants from three states.

Miami University:

O. M. KRIEGMAN has been called to active duty in the Army. He passed the CPA examination in May.

W. P. KEEBLER has been appointed lecturer.

DEAN R. E. GLOS is on leave of absence for the year. C. R. NISWONGER has been appointed acting dean. Niswonger addressed the Cincinnati Chapter of the Institute of Internal Auditors in September.

OKLAHOMA

The Oklahoma Institute on the Internal Revenue Code of 1954 was held in September in Oklahoma City under the joint sponsorship of all the colleges in the state and the Oklahoma Bar Association, the Oklahoma Society of CPA's, and many other professional groups interested in tax matters. The speakers included outstanding accountants and lawyers from all over the United States.

University of Oklahoma:

The University was host in November to the 5th Annual Tax Conference held at the Extension Study Center.

Oklahoma A. and M. College:

B. F. Harrison recently attended the annual meeting of the Association of CPA Examiners held in New York in connection with the American Institute of Accountants meeting.

Clarence A. Black has been added to the staff as instructor.

PENNSYLVANIA

University of Pittsburgh:

Recent additions to the staff include Harold W. Green as instructor, Gilford Frazee as lecturer, and Fred W. Black, Jr., as lecturer.

Louis A. Werbaneth, Jr., has spoken recently before several groups on the 1954 Internal Revenue Code.

The 5th Annual Accounting Symposium was held on the campus in November.

J. H. Rossell and C. L. Van Sickle taught summer conference courses for executives of Westinghouse Electric Corporation.

Lehigh University:

L. C. Lettieri has left to accept a position with a national firm of public accountants. He has been replaced by James E. Wert who completed work for the Ph.D. degree this summer at Ohio State University.

Carl L. Moore is program director for the Lehigh Valley Chapter, NACA.

Raymond G. O'Neill recently passed the CPA examination.

University of Pennsylvania:

T. A. Budd, formerly chairman of the department, has been named acting dean of the Wharton School of Finance.

Adolph Matz has returned to the staff after a two-year leave as industrial cost specialist with the Foreign Operations Administration.

RHODE ISLAND

University of Rhode Island:

Martin Mellman has been appointed instructor in accounting.

W. S. Briggs recently addressed for the third consecutive year the executives of Owens-Corning Fiber Glass on comparative analysis of financial statements.

B. A. Sanderson recently addressed the Rhode Island Farm Bureau on Internal Revenue Code changes.

TENNESSEE

University of Chattanooga:

Jack Frost and William Hamilton have joined the accounting staff of the evening college.

TEXAS

Texas A. and M. College:

Recent appointments include Bill Bishop and John D. Laflin as instructors and William Whittington as associate professor.

University of Houston:

Howard M. Daniels was special lecturer at the University of Texas during the 1954 summer term.

I. E. McNeill received his CPA certificate after the May examinations.

Texas Technological College:

The College was host in October to a special tax conference on the Internal Revenue Code of 1954.

University of Texas:

The University was host in September to a special conference on the Internal Revenue Code of 1954.

VIRGINIA

Virginia Polytechnic Institute:

Frank L. Butler has been appointed instructor in accounting to replace Lloyd J. Buckwell.

L. M. Harrell, Jr., was recently elected president of the Southwest Chapter, Virginia Society of CPA's.

William S. Gay, a member of the State Board of Accountancy, recently delivered a paper on reasons for failures on the CPA examination at the fall meeting of the Virginia Society of Public Accountants.

BOOK REVIEWS

ARTHUR M. CANNON, *Editor*

Accounting

Auditing

Economics

Finance

General

Taxes

Teaching

Accounting

NORMAN E. WEBSTER, compiler, *The American Association of Public Accountants, Its First Twenty Years* (New York: American Institute of Accountants, 1954, pp. vi, 402, price $5.00).

NICHOLAS A. H. STACEY, *English Accountancy, 1800–1954* (London: Gee & Co., 1954, also Staples Press Inc., New York, pp. xvii, 295, price $5.50).

Because accountancy is a technology with professional overtones, its history could be presented from either of two points of view. As a technology, accountancy has a record of service extending over more than four centuries; it has shown an amazing versatility of application, particularly in its modern setting. A historian might view this long technical evolution of service and undertake to find, in the surrounding economic atmosphere over the centuries, some explanations for the appearance of these techniques and for the changes therein which have widened its usefulness so greatly.

The first approach would examine technical characteristics interpretatively as to origins and significant uses; the second would focus attention upon technicians banded into organized groups which, under the impact of modern social conditions, eventually became professional bodies having a recognized function and a statutory status.

Both authors named above have cast their work in the mould of the second and more limited objective, the one writing about accountants in Great Britain, the other about accountants in the United States.

Mr. Webster disclaims authorship as such by signing his title page, "compiled by Norman E. Webster, chairman, Committee on History." His presentation is limited to the period from 1886, the time of the organization of the American Association of Public Accountants (ancestor of the present American Institute of Accountants) to the year 1906. The latter date was selected because thereafter ample materials are available "from which a well organized history of those years may be written . . . at some future time."

This book may therefore be considered a public service action of the American Institute in making available the factual details of the first twenty years of organized activity of American public accountants. The book is moreover a monument to the vast patience and increasing persistence of an editor who had developed those qualities through a long career in public practice and then, at a time when most of us would have chosen an easy chair in a shady spot with a good view, applied his talents to a long search for widely scattered, nearly forgotten original data, and to the laborious task of sorting and classifying an astonishing mass of documentary materials and periodical items. The same editor gave much the same service to the New York State Society in connection with its *Ten-Year Book*.

In Webster's book we find no editorializing, no philosophizing as to causes or effects; only organized factual data and extensive but selected quoted extracts from organization minutes, relevant correspondence as available, and pertinent editorial or news paragraphs from contemporary periodicals and newspapers. The people who were active in accounting matters during those years receive abundant consideration. The seventy-five pages of biographical data for more than 200 individuals clearly indicate that the editor has maintained an interest in people although for many years immersed in a sea of figures. Late in the book he writes: "There is a voluminous literature on the technical aspects of the profession but only a little space on the shelves is necessary for storage of the works on the human side of accounting practice, its individual firms, societies, etc., the side to which an effort has been made in the preparation of this story of the first twenty years of the Association."

Mr. Stacey, the British author, is a relatively young man who has had considerable contact with British accountancy through his activities as assistant secretary of the Association of Certified and Corporate Accountants, and as editor of *The Accountants Journal*. His pages also indicate a wide acquaintance with social and economic history, an aspect of his preparation for this writing which was no doubt reinforced by the time recently spent in lecturing and research in the Graduate School of Business at Columbia University. His approach to his subject is suggested by the phrasing of the title, *English Accountancy, 1800–1954*, and his subtitle, "a study in social and economic history."

If we must say that the American book is by design something less than a history of a time segment of the profession in the United States, it is appropriate to say that the British book is somewhat more than a history of organizational activities, for it is largely concerned with the impacts upon business of the circumstances and ideas inherent in economic development, which impacts, being transmitted through business to accounting, became causal factors tending to make understandable both the growth in the use of accounts and the clash of conflicting ideas among various organized bodies of British accountants.

A project such as this obviously necessitated a vast amount of research and studied consideration, not only of the facts about organizational actions and attitudes, but also about the facts and the significance of events characteristic of the developmental phases of modern economic society.

Although the period involved covers only a century and a half, it marks a time of great changes in the economy of the nation and the empire. It is a time therefore likely to generate conflicts between people strongly saturated with the way things have been and people strongly influenced by the way conditions have changed.

Perhaps the essence of the book could be compacted into these sentences: British productive activities in the nineteenth century constituted a part of world trade carried on by large corporations. Statutory audits arose a century ago as a means by which government, acting for society, undertook to protect security investors against a repetition of early frauds and misrepresentations by company promoters and/or directors. In rela-

tively recent years efficient production and effective company management have become a matter of such concern that earlier accounts, even though they still are thoroughly audited, no longer sufficed for the needs of the times. The basis for an expanded and improved use of accounting lies in this sequence of development. The same sequence indicated the framework in which a statutory profession of auditing appeared and later expanded, not without some of the friction natural to a dynamic and democratic society.

The book may seem hard reading in spots because of the extensive consideration given to economic conditions, social changes, and statutory developments. Yet it may well be that these aspects are the ones which constitute the author's major contribution. For accountancy is what it now is because of conditions that existed in the past, and today's industrial economy is what it now is because accounting technology has contributed to its development.

Stacey gives the reader a frank preview in the preface of his forthright attitude toward his subject. Accounting development, he points out, has been strongly conditioned by its economic climate. It is therefore necessary for a historian to appraise the natural and artificial obstacles to its progress. He prepares the reader early for the spots of interpretative criticisms which appear throughout the work. In the preface the author writes: "... accountancy is too important a professional service to be left solely in the hands of its practitioners" because they are "too preoccupied with the esoterics of their work" to plan how better to focus their art in aid of solving contemporary problems. He sees accountants, because of preoccupation with their craft, becoming divorced from conscious contact with economics of which accountancy is a part. This interpretation is supported by the slowness of British practitioners to orient accountancy toward aid to enterprise management while continuing to serve investors by providing audited balance sheets. There also seems to have been an unfortunate lack of interest for research in accounting theory, accompanied by an overemphasis upon pragmatic and traditional ways.

In the same vein the author writes (p. 38): "By the middle of 1880 the art of accountancy showed signs of stratification, a state in which it remained, at least in some respects until the twentieth century.... In two aspects in particular this dead hand of conservation survived an incredible length. These are accountancy training and education, and the evolution of dynamic management accountancy. In a sense one is the corollary of the other." The essence of an important later section of the book, one dealing with the period 1940–1954, seems to be that toward the middle of the twentieth century technical education and the art of managerial accounting had made a substantial beginning, yet one which, in the author's opinion, still leaves much for the future to accomplish.

If a reader of Webster's book wished a sample of its essence, he would find it between pages 163 and 325. Here in about one half of the volume is presented the important work of the American Association in connection with early CPA legislation, ideas and achievements in technical accounting education, and types of cooperation with other societies of accountants.

Similar areas of activity can also be seen reflected in the British book. Legislative success and failures were experiences in both countries: in Britain nationally through the long series of Companies Acts which gave status to auditing; in the United States through CPA laws in the individual states. Accountancy recognition through the Companies Acts extended from 1862 to the statute of 1948 and the present time; recognition in America, to the extent of exclusive use of the title "CPA" and in some states including registration of practitioners and restriction of practice to those registered, extends from the first CPA law in New York in 1896 to the present time.

Competing societies of accountants appeared in both countries. Perhaps this came to be a smaller problem here than abroad because we had state societies with functions distinct from those of a national body. At times state society prerogatives were strongly advocated by separate national organizations (such as the Federation, 1902–1905, and the American Society of CPA's in the 1920's) even when this brought disagreement with other contemporary national groups (such as the American Association and later the American Institute). In Britain differences between societies of accountants arose out of opinions regarding admission requirements, field of primary professional service, and statutory status. Most of the problems between American organizations were resolved by the time the Institute and the Society merged in the 1930's and a council of state society presidents was given a place in the work of the Institute. The examination service provided by the Institute since 1917 (and now used by all state boards of examiners) was a major factor in modifying existing interstate friction growing out of differing CPA laws and board regulations.

Both authors give considerable attention to education for accountants, each according to circumstances peculiar to his respective country and the time period involved. Because of the terminal date in Webster's book, education is there considered only in connection with an abortive attempt in the 1890's by the Association to establish a technical accounting school and with the successful launching of an evening school of accounts at New York University in 1900. Just as the CPA law of New York established the pattern of subsequent state legislation, so too this school established a pattern for part of the later expansion of technical education. Soon, however, full time colleges of commerce were offering degree programs which associated accounting studies with other business subjects and with a substantial content of general education. This has come to be the typical pattern here and one which brings an increasing flow of broadly prepared personnel into public and private accounting work. Degree graduates having accountancy and business administration as their major subjects are in strong demand from professional firms and business corporations. Many of these employing organizations now have continuation training programs designed quickly to erect a bridge between classroom study and direct contact with accounting in

the respective settings.

Stacey clearly indicates various aspects of British attitudes which long delayed the offering of appropriate education in science and in business in the universities. Some of the same attitudes, evidenced by excessive conservatism and complacency, he considers to have stood in the way of a more rapid development of the arts of enterprise management suitable for modern conditions. In other places he does not hesitate similarily to criticize attitudes which led men to resist proposals to unify and modernize accountant societies.

To some readers the British author may seem overly critical. Yet it should be observed that frank criticism, after the fact as well as at the moment, is a very useful aid to the satisfactory working of a democracy. Such for example is the result of the attitude of Her Majesty's loyal opposition. Hence a writer may regret slowness to change and opportunities missed, and at the same time contribute to ultimately satisfactory outcomes by pointing in history to a succession of disappointments which, viewed in retrospect, reveal neglected opportunity for a swifter transition. Perhaps knowledge of earlier delayed transitions may smooth out or speed up present and later transitions. The need for adaptability will not disappear with the solution of present problems.

As an earnest historian, Stacey does not hesitate to be interpretative. The attitudes of the time, the failures and successes in nineteenth century British business and accountancy, were what they are now known to have been because of the economic and social setting. He is helpfully interpretative not only in uncovering specific influences but in pointing as well to the reverse—the beneficial effect that required accounts and audits had upon the continuing success of business enterprise. His major point is that it would seem to have been perfectly possible for accounts and business management to have evolved faster in the direction we now see they had been moving.

It is obvious throughout this work that the author is deeply conscious of the forces and movements which affected British life and industry over the past century and a half. Perhaps it is this fact which enables him to make the largest contribution of the book: the interweaving of threads of technology and professionalism into a fabric of industrial, economic, social and political change. If one reads first the 1940–1954 sequence, he will probably find himself caught up in the essential theme—the interrelation between an economy and a technology. He will then wish to read the prior sections, decade by decade, dealing with the gradually developing interaction of the two factors over several generations.

This 1940–54 sequence is particularly rewarding, for in 86 pages it epitomizes the problems faced in accountancy throughout most of a century and a half, and reports upon the present status of those problems. Subsections deal with effects of the war, managerial accounting, influence of and on company law, professional progress, education, and outlook toward the future.

In this section, as elsewhere, the author courageously criticizes a continued slow approach toward modernization and is frankly critical of earlier conservatism and complacency in both business management and professional accountancy. For example, after many years of debate, a plan of unification for the profession, under registration for public practice, acceptable to the established accountant organizations seemed achieved in 1945. Yet in the revision of company law in 1948, this plan became an accomplished fact only in a very disappointing degree. "Provincialism," he writes at page 240, "in the ranks of the councils of the various bodies" stood in the way though they seem to have agreed to the draft proposal. "If the profession wishes to assure its continued ascendancy, it must speak with one voice." Thus the author indicates his own present disappointment.

It will be evident to American readers that even this failure constitutes a much closer approach to nationwide restriction of public practice to registered qualified accountants than has been achieved in the United States, where only a few individual states have such legislation. Here registration has been advocated only in connection with professional auditing. In Britain the proposal asked statutory recognition of several non-audit organizations of accountants which gave qualifying technical examinations for admission. This seems to express the broader concept of "professional accounting." When one thinks of the service to society rendered by administrative accounting and accountants through aid given to improved techniques of enterprise management and likewise notes the increasing use of technically trained accountants in governmental divisions, where in the United States at least commercial accounting technology is being adapted to new uses, it becomes apparent that a broad concept of "professional accounting" would be appropriate here also.

There is no space in a book review to examine into the similarities and differences in the problems faced by accountants in the two countries. Stacey's book will provide abundant materials on his side for someone to draw upon who is familiar with the major problems on our side. Webster's book only takes us to 1906. Yet even in that double decade similar situations appear, and other similarities together with elements of difference are known to characterize our years between 1907 and 1954. We ought not have to wait for a full presentation of the American story now that the British story is available. A solid analytical article could reinforce our natural feeling of kinship while our own history was being written.

The development of accountancy is an intricate fabric that has great length and complexity. The warp and woof has been woven; yet, for the lack of written history, we can only dimly know the unfolding pattern, each one according to his own small contact with the facts. It has been outside the intention of these authors to attempt to present the whole of the pattern. They have taken a more or less limited and modern segment under examination. Other explorers of parts of the whole pattern should be encouraged to sharpen a spade and dig. Out of an accumulation of separate studies such as these two, gradually will come the power to comprehend and picture forth what really lies within this service technology and within the profession which

has done and can still do so much to make accounting an effective instrument in the service of modern industrial society.

We particularly lack historical studies of the evolution of the technical aspects of accounting as a technology. We have a sizable literature on accounting technique, but no history of its beginnings and advances. It is important that this technology with its large potentials for expanded service, shall steadily grow in capacity to serve. Written history can provide perspective from the facts of past changes and the settings in which new applications of that day grew by use from ideas of the day before. We may hesitate to consider economics a technology; and compared to the antiquity of the basic methodology of accountancy, we note that it is of more recent origin as an organized discipline. Yet many authors have contributed significantly to our ability to understand an economic society by laboring to present economic ideology in a historical setting.

It is not enough to know the facts about actions taken and the men responsible for the actions, interesting as this may be. No historian is willing to indulge in pure speculation regarding cause and effect. Yet, if history of the past is to contribute to the development of the present, readers at the later date must be able to catch some glimpses of those prior conditions and ideas which stimulated known actions, and glimpses of the way that these actions subsequently stimulated ideas, favorable or corrective. We would like to have some idea at least whether a present need is for continuation of past attitudes or for new attitudes. This we might learn from the past—if its story were available to us.

It is true that power to penetrate causation is not given to men. But there must be some middle ground above unsubstantiated speculation. Perhaps that would be the area, so skillfully used by this British author, of thoughtful interpretation of antecedent circumstances and ideas as having possibly and plausibly conditioned later ideas and events in not unreasonable ways. At least we have to say that at any given time even laymen must of necessity try to surmise a plausible near future out of whatever materials they may possess. The historian will be better equipped than any layman to see some distance into the interrelation of causative factors and subsequent actions, for he has factual knowledge of both the earlier past and the then future. Would it not seem therefore that the historian would most help his readers by developing and exercising a skill in interpretatively, even if inconclusively, looking at events and ideas against a background of antecedent conditions and thought?

Stacey concludes his book with some helpful observations in the later pages as to the future.

The major emphasis, he thinks, may shift from audits to wider services, such as helping keep peace between management and labor, umpiring between company, shareholders and the state, assisting in avoidance of economic upheavals and social unbalance. Change in economic climate and various social imitations, he believes, must inevitably bring the ordering and balancing of production and distribution under decisions made by officials in a welfare state. The vehicle of such control is careful forward planning; an important instrument in aid of this planning is an accountant applying his special techniques.

In the United States we have not had practical experience with nationalized industries. Yet some American writers on the methods of assembling and presenting statistical data regarding national product and income have begun to call that arrangement of figures "social accounting." Such statistical tables may be "social" in significance, but they hardly deserve the other descriptive term "accounting." This shows a term taken over from one technology and applied regardless of its other connotation to a different technology.

It is some times urged these days that accounting technology should be modified in the hope that in its new form it would become of even greater service to society—that is, to governmental management of society—than it now renders through the accounts of business concerns. If the profession of accountancy is to inherit large responsibility in attempting to modify accounting in the hope it may then help society achieve a desired degree of economic stabilization, would it not be advisable greatly to accelerate the accountant's education in economic theory and statistical methodology, perhaps substantially equal to the best (technical, present) education in accountancy as such? How long would it take, in either country, to achieve this goal? Assuming it could be and were achieved, in due time, would the modified accounting technique be able to make its presumed contribution to economic stabilization in the face of forces and factors beyond the reach of these techniques, whatever their design might be? Future historians may have to examine into such questions in retrospect. We might save them and many other people some headaches if we pondered similar problems thoroughly in the present.

A. C. LITTLETON

Denver

HOMER ST. CLAIR AND EDWARD J. KOESTLER, *Basic Accounting, Part II* (New York: Pace & Pace, 1954, pp. viii, 392, price $6.50).

This is Book II in the Pace Accounting Series. It is a worthy sequel, in matters that count, to Book I (see ACCOUNTING REVIEW, October, 1954). Together, Books I and II provide a balanced, earnest treatment of what normally passes for "first year" accounting. The books have innovations, but these add to their strength and value as texts.

Book II, like Book I, is divided into eight sections. *No. 1* (pp. 1–34) takes up working papers. This section is as complete as can be found in first-year texts. There is a plus feature in the attention of various types of working papers used to facilitate calculations for month-end entries and monthly reports. An example is the working paper schedule for unexpired insurance.

The next four sections deal with journalizing and posting techniques, and related records and mechanical aids. In *No. 2* (pp. 35–65) the subjects are cash records, cash reports, purchase records and sales records. In *No. 3* (pp. 66–87) the subject is the voucher payable system. An unusual feature here is the use of individual vouchers

to make working paper analyses of expenditures. In *No. 4* (pp. 88–116) the topics are notes receivable and payable, note registers, columnar journal, and the "all in one" journal, suitable for a small concern which wishes to exploit the special column principle without going all the way to specialized journals. In *No. 5* (pp. 117–170) the discussion turns to ledger records. An unusually large play is made of the "private ledger," variations in ledger forms, ledger bindings and office appliances.

No. 6 (pp. 171–199) is a study of a variety of subjects falling within the field of financial statements. Included are comparative statements, ratios, how to construct a statement of funds received and applied, gross profit method of arriving at the inventory figure or checking the accuracy of it, budgetary procedure, and the "single entry" method of computing profit for a period. The discussion in each of the subjects is adequate, keeping in mind the elementary level of exposition.

No. 7 (pp. 200–227) covers two topics which are either slighted or ignored altogether in other first-year texts. The first is the procedure—common in small businesses—for keeping books substantially on a "cash basis" from day to day, then converting to a full accrual basis at the end of the period for purposes of financial statements. A continuous case is used to illustrate procedure for two successive periods, thereby giving the subject the realistic treatment it deserves. The second topic in this section deals with procedure for recording the liquidation of a concern which is going out of business.

No. 8 (pp. 228–273), the final section, bears on partnership accounting. The order of presentation is easy to follow. First come definitions of terms; then follow opening entries for a new firm, division of profits or losses, addition of new partners and withdrawal of old ones, allowances to partners for salaries, interest on capital accounts, form and arrangement of partnership statements, and sale or liquidation of the firm. Inevitably, there is a discussion of partnership goodwill. (Luckily for accountants, the determination of the amount of goodwill is usually the responsibility of partners.)

In the back of the book are some 113 pages of exercise material for written assignments. Each section of text is provided with a set of questions and a set of problems. These appear ample in variety and length and allow teachers alternate assignments in successive years. All exercises have met the test of successful classroom experience the country over.

Harry D. Kerrigan
Professor of Accounting
University of Connecticut

Clarence B. Nickerson, *Cost Accounting* (New York: McGraw-Hill Book Company, 1954, pp. xii, 462, price $7.00).

Nickerson's *Cost Accounting* is one of the Harvard Problem Books. Its distinguishing feature is its extensive employment of the "case method" to teach cost accounting. While cases are used to provide practice in problem solving, as in the conventional text, they are, in addition, used as a device to teach principles and procedures in each phase of the subject. Textual material occurs to some extent throughout the book but the author depends principally upon cases to achieve his objective of helping students of cost accounting to develop a basic understanding of the subject and its use in business.

A case, Professor Nickerson states, is a description of an actual business situation, involving problems, decisions and action, intended to develop in the students certain powers and skills in approaching and handling business situations. Professor Nickerson in applying the case method to cost accounting uses cases requiring study of the described business situation and either an appraisal of the costing techniques employed or consideration of cost accounting questions raised with respect to the described situation. The solution in most instances, it seems, would be presented in either oral or written report form possibly with supporting schedules of data.

There are fourteen chapters in the book and while they are not grouped, they do appear to divide into four parts. The first is the introduction which deals with the field of cost accounting and the application of the case method to its study. The second part comprises chapters two to seven and is devoted to topics commonly presented in cost accounting texts. The third part, chapters eight to thirteen, is a treatment of what might be termed managerial planning and control. The fourth part is the concluding chapter, number fourteen, and, like the second part, its subject matter is presented to some extent in most cost accounting texts.

In the first section of Chapter I the author presents textual material respecting the field of cost accounting, its use and importance in business management. In the remaining three sections he discusses the case method and case analysis, introduces a four page case example regarding the use of cost accounting in the control of operations, and makes a commentary upon it. He concludes with a case designed to stimulate students to think about and discuss the need for cost accounting and its use to management.

In the next portion of his book the author discusses Inventory Valuation and Profit Determination. Five cases provide an opportunity for study and discussion of separate methods of valuation including the application of Lifo to retailing. Following upon this the author presents methods of Cost Accumulation. A series of cases is used to explain and illustrate records, systems and cost allocations.

In his discussion of Standard Costs the author develops the setting of standards, and points out briefly some of the ways in which standard costs are used in accounting systems and the treatment of variances. This is followed by cases, two of which explain establishing a standard cost for a product and the operation of a standard cost system.

In his explanation of Variance Analysis, the author carefully develops and illustrates the computation of material, labor and burden variances. There is a thorough treatment of the types of total burden variances and also the nature and analysis of variable and fixed burden. The extent to which a variance may be the responsibility of individual personnel is given atten-

tion. There is very little consideration of the disposition of variances.

The next subject is Cost Accounting for Government Contracts. Professor Nickerson reproduces *Armed Services Procurement Regulation, Section XV—Contract Cost Principles* and relates an excellent case respecting Navy contract work. This is followed by Special Problems of Factory Burden with a case on the cost of idle plant and some timely notes on Direct Costing.

At this point the author introduces a distinctive contribution. He presents a clear exposition of Cost-Price-Volume Relationships and Budgetary Control. Methods of tabulating, charting, and revealing cost-price-volume factors are fully explained and illustrated, including the method of least squares. The Break-even chart and the Profit-Volume chart, their use and limitations, are adequately discussed. Problems included give an opportunity for practice and understanding in this important field.

The author in his discussion of Budgetary Control forcefully explains the difference between fixed (static) and variable (flexible) budgets. He uses a series of cases to clarify budgetary control in manufacturing and distribution type business situations and administrative and selling functions. An excellent case explains and illustrates the preparation of a financial budget.

In discussing Cost Elements in Pricing, Professor Nickerson uses an economic approach, drawing upon the writings of the neo-classical economists, especially the eclectic analysis of Alfred Marshall.

What might be termed the managerial planning and control phase of the book is rounded out with useful cases exemplifying Problems of Alternative Choice. The author concludes his book with three cases as Examples of Variations in Costing Procedures.

Professor Nickerson's *Cost Accounting* is quite unlike the usual cost accounting text. It will give the student knowledge of the field of cost accounting. The cases bring out problems and practices in costing, achieve an integration of business functions and reveal the needs and thinking of management. There is a bare minimum of procedural training. Nor does the book bring out to any extent the theory supporting many practices discussed. It will be most valuable as an exposition of how cost accounting can serve in management. The book would be especially suitable for study in courses organized as seminars.

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Auditing

Walter W. Bigg, *Spicer & Pegler's Practical Auditing*, 11th Edition (London: H.F.L., Publishers, Ltd., 1954, pp. xxiii, 501, price 27/6).

The first edition of *Spicer & Pegler's Practical Auditing* was published in 1911 and subsequent editions have kept the text up to date. Mr. Walter W. Bigg, the present author, has been associated with the text for the past twenty-five years. In the preface to this edition Mr. Bigg states that he has taken this opportunity "to reset the book in a style which adds to its attractiveness and at the same time reduces its bulk." He has also included the recommendations, where appropriate, of the Council of the Institute of Chartered Accountants in England and Wales.

How does this book differ from our American texts in make-up, style, presentation, etc.; and how do the accounting and auditing concepts presented in this book differ from those which have been developed in this country?

The organization of the book differs considerably from that of current texts published in the United States. Typically, auditing texts in this country, after disposing of introductory material relating to the purpose of auditing, the practice of public accounting, the planning of an audit, and audit working papers, develop the important concept of internal control; then the audit of each major classification of the balance sheet is presented in the order in which the item appears in that statement. This is generally followed by a discussion of the audit of revenue, cost and expense accounts. Finally, the audit report and certificates are presented.

This English text, after disposing of the introductory material, presents a chapter on "The Audit of Cash Transactions." Although some mention is made of internal check as it affects cash, there is no complete presentation of the subject of internal control. For example, there are no organization or flow charts such as one might find in our audit texts.

Chapters 2, 3, 5 and 9 present familiar auditing subjects; chapter 4, however, deals more with accounting theory than it does with auditing. Except for chapter 9, chapters 6 through 11 present subjects that are not emphasized in American texts, although, of course, many of the subjects may be mentioned. To illustrate, the author has devoted an entire chapter to appointment and remuneration and another to liability of auditors, subjects which are discussed in our *C.P.A. Handbook*.

American textbooks on auditing stress the detailed auditing steps which may be encountered in the examination of each specific balance sheet account. In doing this, not only are audit procedures explained but usually an attempt is made to discuss *why* the audit procedure is performed. In this reviewer's opinion *Practical Auditing* should have given more attention to this question of *why* in presenting auditing procedures.

The Companies Act of 1948 is of course most important to accountants in England, and the author has rightfully given considerable attention to it. The Act not only provides for the method of appointment of auditors at the annual general meeting of limited companies but also states the qualifications required of the auditor. The auditor must be authorized by the Board

of Trade or by a member of one of the five bodies of accountants recognized by the Board of Trade.

The Act provides that if the present auditor is given notice that a resolution to appoint another auditor will be introduced at the annual meeting, he "may make representations to the company in writing" and ask that they be sent to the members of the company. Furthermore, the "retiring auditor has the power to attend the annual meeting at which his removal is to be proposed and to address the members." The author emphasizes the fact that the company in general meeting has the ultimate right of appointment of auditor and his statutory duties are owed to them. It is interesting to note that the Companies Act of 1948 gives the auditor the statutory right of access to all books and accounts and vouchers of the company.

The author spells out in detail the duties of the auditor as provided by the 1948 Act. Among other things, the following form of the auditor's report is recommended:

> "I have obtained all the information and explanations which to the best of my knowledge and belief were necessary for the purposes of my audit. In my opinion proper books of account have been kept by the company so far as appears from my examination of those books. . . . I have examined the above Balance Sheet and annexed Profit and Loss Account which are in agreement with the books and accounts. . . . In my opinion and to the best of my information and according to the explanations given to me the said accounts give the information required by the Companies Act, 1948, in the manner so required and the Balance Sheet gives a true and fair view of the state of the company's affairs as at . . . and the Profit and Loss Account gives a true and fair view of the profit (or loss) for the year ended on that date."

In chapter 9 the author included an illustration of a typical published profit and loss statement and a balance sheet. There are very few illustrations in the text other than these. No questions or problems are given in the text.

One major difference in audit philosophy in the two countries is illustrated by the emphasis Mr. Bigg places on vouching transactions. Obviously, the auditor must be thorough; however, this reviewer has the impression that in England many more transactions must be vouched than in the United States. This difference in audit philosophy may be partially the result of the apprenticeship system of educating accountants in England in contrast to the policy in this country of employing persons with university training.

The author points out, in another difference in philosophy, that the accounting profession in the United States has ". . . formally acknowledged the physical verification of inventories to be part of normal auditing practice. . . . This view has attracted a certain amount of support in this country, and many auditors do, in fact, carry out some sort of a test check of the physical existence of the stock. It is, however, pertinent to question the practical value of such a procedure, having regard to the auditor's unfamiliarity with the diverse types and qualities of the articles included in the inventories. The auditor should not be expected to accept responsibility for work which his professional training does not qualify him to perform efficiently, and the only physical examination of the stock that could possibly be relied upon would be one carried out by professional valuers with an expert knowledge of the particular trade."

It is the reviewer's opinion that both practitioners and academicians will find this standard English text on auditing very interesting. Particularly useful would be the material relating to the Companies Act, 1948. Certainly those interested in the problem of current values for fixed assets would want to read the pronouncements on this subject by three of the accounting organizations in England. Finally, the practitioners should read chapter 10 on "The Liability of Auditors."

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Ernest Coulter Davies and John H. Myers, *Audit Practice Case* (New York: The Ronald Press Company, 1953, pp. iii, 312, price $6.75).

It is sometimes difficult for students who have had little or no contact with actual accounting records, and whose concepts of auditing procedures are limited to such ideas as they may have obtained from an auditing text, to visualize the problems involved in actual practice. These authors have attempted to provide materials which will enable a student to perform "the basic duties of a junior accountant in charge of a small audit," and which will help him to achieve "a high degree of efficiency in regular auditing practices."

The materials are presented in five separate paper bound booklets. Part I includes instructions to the student who is considered to be an employee of an auditing firm. General data regarding the client, his organization, personnel with whom the "junior auditor" is to be associated, type of product and methods of manufacture are presented. Every effort is made to present the material in the most realistic fashion possible. Included are conferences with various people from whom information must be obtained in the course of the audit. Also included are miscellaneous papers such as bank statements, deposit tickets, inventory sheets, tax receipts, invoices, etc. The authors feel that the student acquires some needed practice in actually handling business papers and some additional familiarity with them.

Part II is composed entirely of business papers, checks, paid and unpaid invoices, to be examined by the junior auditor in the course of his work. Part III contains the Voucher Register, Check Register, General Journal, Payroll Register, Cash Receipts Book, and the Sales Journal of the client company. Only the month of December is presented in detail with a sufficient number of January transactions to make possible the necessary tests of the subsequent month. Many schedules have been "partially prepared" by the client's staff, which is a

further saving of the student's time. Ledgers are contained in Part IV. Accounts Receivable are reduced to about the minimum number that may be required, again in an effort to conserve the student's time, yet provide the essential aspects of a complete audit. Working papers for the prior year are complete in Part V and are a starting point and a guide for the student in the preparation of his own working papers.

The case is designed to be used with any standard textbook. Assignments may be modified to suit the time available to the instructor in the particular case. The set might also be used for on-the-job training programs, particularly where instruction is confined to actual auditing work.

Due to the manner in which the material is presented, the student has an opportunity to examine the system of internal control, and to make recommendations where strengthening is desirable. No report is provided for the prior year, the student being thereby prevented from stereotyped copying.

While it is undoubtedly impossible to duplicate actual business conditions in any type of practice set, it is true that the business papers and the construction of actual working papers will, in all likelihood, give a better idea of the conditions to be encountered on the first actual audit. Certainly it will aid materially in assisting the student to understand the basis for the efficient construction of an adequate set of working papers. It is not intended to replace or substitute for a textbook. It should rather be used as a supplement thereto, lending force and understanding to the mechanics of the auditing procedures theoretically developed in a competent text.

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Economics

Erik Lundberg (Editor), *Income and Wealth, Series I* (Baltimore: The Johns Hopkins Press, 1954, pp. vii, 297, price $4.25).

This volume is one of three bearing the title *Income and Wealth* (Series II and Series III are not reviewed here), representing the first publication fruits of the new International Association for Research in Income and Wealth, organized in 1949. A 1954 publication in the United States, the book was first published in England in 1951. It presents eight selected papers drawn from those given at the first meeting of the new association held at Cambridge, England in the fall of 1949. The papers represent contributions of persons from several countries, as well as from the staff of the United Nations, and deal with three topics in the field of national income research: social accounting, the treatment of government in social accounts, and the problems involved in intertemporal comparisons of real national income. The other two volumes (Series II and III) present topics dealing with a world-wide study of the economic growth of nations, international comparisons of national accounts, and various problems dealing with the sources and reliability of national account estimates.

The first paper, which occupies one-fourth of the volume, is an extended and excellent discussion by Richard Stone of Cambridge University of "Functions and Criteria of a System of Social Accounting." The first part of this very thorough treatment is of some interest to the layman as an excellent statement of the functions and purposes of a system of social accounting and a clarification of many issues regarding the advantages of a system of balanced accounts. Much of the article will, however, be of interest primarily to specialists in the field of national income accounting, as a great deal of detail is gone into regarding such questions as the appropriate number of sectors into which the economy should be divided for social accounting purposes, the desirability of treating the purchase of consumer durable goods as capital expenditures rather than consumption, etc. To the three economic sectors (enterprises, households, and government) which are today commonly used in national income accounting, Stone suggests the addition of two more, labor and "lending." He argues that the traditional assumption that all expenditures for the maintenance of workers are properly classifiable as consumption is erroneous, or at least insufficiently precise. By classifying labor as a separate sector he suggests the possibility of classifying such expenditures for the maintenance of labor as the purchase of clothing and tools, perhaps the expense of travel to and from work, etc., as intermediate expenses of production rather than final consumption expenditures. His reasons for wishing to classify lending, that is, the making of loans and the receiving of interest, as a separate sector are less fully presented. All the logic seems to favor his suggestion that the purchase of durable goods such as automobiles should be regarded as capital expenditures, an annual depreciation charge being calculated as consumption expenditure.

The paper by Gerhard Colm, staff member of the Council of Economic Advisers, entitled "Experiences in the Use of Social Accounting in Public Policy in the United States," touches a fascinating and vital question: To what extent are policymakers utilizing the array of economic information made available by social accounting in making policy decisions? Mr. Colm begins by observing that he does not believe that the use of national accounting in the United States for "operational" purposes is nearly so great as in some other countries. (This becomes quite apparent after reading a subsequent article concerning the use of such statistics for national planning in Holland, for example.) It was not until the late 1930's that people in policymaking

positions in the United States began to be interested in national income statistics. This interest reflected gradual acceptance of the importance of the government's contributions to disposable income as a recovery measure.

But it was not really until after the passage of the Employment Act of 1946 that attention in the United States was focused upon factors in the national income and expenditure flows that might be considered responsible for the level of employment. Colm suggests that the language of the Act may fairly be interpreted to say that economic policy recommendations should be based on national economic accounts as that term is normally used among economists. In the process of developing this theme Colm has some interesting observations on the use of national accounting in free enterprise economies as compared with those economies more thoroughly "planned." Included also is a description of the nation's Economic Budget as developed in the United States; an appendix by Mary W. Smelker further elaborates this concept, together with many examples drawn from U. S. statistics of 1948–1949.

In an article by Jan Marczewski of the Institute of Applied Economic Science in Paris entitled "Les Experiences Recentes De L'Emploi De La Comptabilite Sociale Par La Politique Economique En France," which appears in French with an English summary, we are not surprised to be reminded that perhaps the first modern example of social accounting appeared in 1758 with the publication of Quesnay's *Tableau Economique*. This paper contains a useful discussion of recent experiences in France with the problems and use of social accounting, in which it is evident that the preoccupation in France has been, understandably enough, with the problems of inflation and the calculation of the inflationary gap.

Mr. E. F. Jackson, of the Central Statistical Office of the United Kingdom, discusses recent British history in the compilation and use of national income statistics in an article entitled "The Recent Use of Social Accounting in the United Kingdom." He points out that there was little concerted effort to derive national income accounts until as recently as 1949. He does not venture any conclusions as to the extent to which British policymakers may now be depending upon national income accounting, but observes that he believes the attention paid to such statistics has "spread in government circles in the last ten years." He incorporates a very good discussion of some of the statistical weaknesses of present data and the ways in which these weaknesses might be remedied.

The outstanding impression one gets from "Recent Experiences in the Use of Social Accounting in the Netherlands," by G. Stuvel is that very extensive and direct use of social accounting statistics is made by the Dutch government in implementing its economic planning. (The author is an official of the Netherlands Central Plan Bureau.) He reveals a degree of faith in the efficacy of planning based on the construction of econometric models that may not be shared by some skeptics.

In the second longest of the eight articles, Simon Kuznets discusses "Government Product and National Income." He explores at great length the question of the extent to which all government expenditures should be regarded as part of the net product of the economy, as well as an appropriate division of government product between intermediate and final product. Space does not permit a review of the issues involved, some of which have already been extensively discussed elsewhere—see, for example, *The Review of Economics and Statistics*, August, 1948. Professor Kuznets believes much of government expenditure should not be regarded as net product, and an additional amount should be regarded as capital formation rather than end product consumption. His case is carefully presented, with many illustrative tables in which imaginary accounts are worked out.

The last two papers in the book survey the problems of measuring national income in real terms and thus providing the basis for comparisons between countries and between different periods of time. Mr. J. B. D. Derksen of the United Nations staff explores "Intertemporal Comparisons of Real National Income: an International Survey," and Mr. W. B. Reddaway of Cambridge University discusses some "Problems in the Measurement of Changes in the Real Geographical Product," the presentations in both cases exploring in a very realistic and practical way present limitations on the comparability of national income statistics in real terms because of the great variation among countries in the techniques used to reduce money data to real terms.

It is not surprising that the volume as a whole gives the impression of offering a great variety of opinions, some diverging very substantially from others, about the character and purposes of national income accounting. As Erik Lundberg says in his editorial preface, it is understandable that the impression should be one of "a certain degree of confusion at the present stage of the development of national income analysis." At the same time, he adds, "It gives . . . an impression of vitality." The articles present a clear picture of people in various countries at work solving the difficult conceptual and statistical problems of measuring national income and its component parts, and of the varying degrees to which such information is coming to be relied upon by governments and by private individuals in the making of decisions that are important to the conduct of economic affairs. The need for exchange of ideas and for the development of more uniform standards among the various countries is clearly shown, and the articles here presented make a good beginning toward the ironing out of these difficulties, differences, and problems. The volume should be of great interest to all specialists in social accounting; but it holds considerable interest, too, for the average reader, who will get a significant picture of the attitude toward, and use of, social accounting in today's world.

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Earl C. Hald, *Business Cycles* (Boston: Houghton Mifflin Company, 1954, pp. xvi, 518, price $6.00).

This book is offered as a text for the undergraduate course in business cycles. Based on the popular income

and expenditure approach, it will very likely be welcomed by many instructors. The book is divided into four parts: (1) the nature of economic fluctuations, (2) a survey of cycle theories, (3) an analysis of the critical aspects of business cycle theory, and (4) the control of business cycles.

The chapters in Part One consider cyclical and noncyclical variations in economic activity, typical cycle patterns, income and expenditure flows in cycle analysis, and the history of business cycles in the United States. The reference dates of the National Bureau of Economic Research are used to determine dates when general business activity turned upward or downward. The author's view is that major cycles encompass at least one or two minor cycles. The development of each phase of the cycle out of the preceding one and of each cycle out of the previous one are stressed. The history of business cycles, while somewhat sketchy for the earlier years, is sufficiently adequate for recent years to lead the reviewer to question the extent to which valid interpretation of changing economic developments can be based on unadjusted comparative dollar aggregates in view of the widespread price changes. Attempted adjustment of such data would, however, probably prove no more helpful for such interpretative analysis of the forces at work over a period of time.

Part Two describes psychological theories, nature theories, the purely monetary approach, overinvestment and related theories, underconsumption theories, and the Keynesian approach. The author wisely refrains from attempting to include any more than representative proponents of the different theories. The views of Pigou and Lavington are presented as typical of psychological theories. Henry L. Moore's rainfall theory and the Jevons' sunspot theory are the natural theories. Hawtrey's views are presented for the purely monetary approach. Hayek's monetary overinvestment theory is related with Schumpeter's stress on innovation. Major C. H. Douglas, Foster and Catchings, and John A. Hobson are discussed in connection with under-consumption theories. The Keynesian approach is considered in terms of its static underemployment equilibrium theory and in terms of its cyclical aspects.

Part Three considers turning points, money elasticity and the cycle, saving and investment as factors in the income level, consumption and investment, the international aspects of cycle movements, and business and economic forecasting. Some repetition in the book arises from the way Part Three is written. The author incorporates his own analysis of each of the aspects of business cycle theory mentioned in the first sentence of this paragraph with the theories discussed in Part Two. Each of the chapters is designed to be complete in itself.

That a complex interrelationship of forces is responsible for the business cycle, and the fact that there is no single causal explanation permitting a simple remedy, are stressed in various places throughout the book. In the same vein, the difficulties of forecasting are squarely faced.

These conclusions scarcely imply, however, that a mere multiplication of policies would solve as many problems as they would create. Yet the application of varied and easily contradictory policies at one and the same time appears to be recommended in Part Four which deals with monetary policy, fiscal policy, the maintenance of private spending, public works, wage and price policy, and prospects for stability, It is difficult to be entirely certain of the author's stand on some of the views propounded. On major points, however, there is little question. Keynes and Hansen retain a preeminent position. On monetary policy the author goes beyond traditional credit control measures in expressing a favorable attitude toward "some of the more extreme proposals for velocity stimulation and purchasing-power injection" (p. 418). Acceptance of proposals for taxing idle balances follows from the unrealistic proposition that "changes in money velocity are properly described as hoarding or dishoarding" (p. 407). In connection with fiscal policy, redistribution of income by progressive taxation is considered desirable in order to increase consumption. Abandonment of the objective of balancing the federal budget annually is regarded as necessary. This recommendation is presumably meant to imply that the budget should be balanced in periods of prosperity when the debt might perhaps be reduced (although the author is not especially concerned with debt reduction). As everyone knows, however, the federal government has in recent years of prosperity made little progress in balancing the budget. It is in fact easy to see the difficulty of changing from an unbalanced to a balanced budget, whereas the change from a balanced to an unbalanced budget is facilitated by the proverbial propensity of governments to spend more than they receive.

The discussion of public works from the point of view of their effectiveness in countering recession and depression considers weaknesses in administration, finance, and timing. In emphasizing the uncertainty of private investment and stressing public works principally in the role of countering recession, the book reflects the tendency of the literature to obscure the fact that public works outlays themselves have been making very definite contributions to booms. With this factor more actively in mind, policy recommendations might come to be somewhat altered.

As a result of the objectification of the so-called business cycle as a phenomenon equivalent to that studied under controlled conditions in the physical sciences, it was to be expected that a desire for analogous control of the cycle would develop. The extent of the control sought determines the lengths to which recommendations go. The present book, for example, says that Congress has not given sufficient power to the Board of Governors of the Federal Reserve System. Also, congress does not follow an "appropriate" tax policy. More important, if Congress will not give the Executive "power to change tax rates and government spending, and to manipulate other comparable weapons," perhaps it might give the President power to make "limited changes in income tax rates at his own discretion" (p. 496). But, unfortunately, according to those embracing such views, "there may even be some questions of constitutionality involved" because of the "tradi-

tional"[1] view that levying taxes and appropriating money are legislative prerogatives.

The book is in accord with widely-held views when it advocates placing "administration of cycle control weapons largely in the hands of our best-informed and most expert interpreters of economic trends and developments and to trust in their ability to make wise decisions. . . ." The work of these elites would involve "trial and error methods" and "day-to-day and week-to-week 'tinkering.'" For impatient advocates of such proposals, "appropriate legislation" conferring "real powers" on the President and the executive branch unfortunately "waits on the slow process of education of the Congress or perhaps of the electorate" (p. 490).

Before World War I, economists in this country were, in Wesley C. Mitchell's words, "student bystanders." Following the declaration of war, many of them were drawn into the federal government to participate in the administration of the economic aspects of the war effort. The large number of economists serving the federal government in the 1930's was followed by even larger numbers in World War II. As Heimann says of the earlier cameralists, they "gave advice on fiscal policy to their lords and fellow officials."

The earlier mercantilist governments were preoccupied with the development of empire, the need for money for war purposes, the promotion of nationalism instead of the interests of the individual, and the encouragement of wider private business activity mainly as a source of state revenues. Although the economic features of what appears to be a comparable present-day program are stated in terms of full employment policies, they are nevertheless said to require increasing interference in individual affairs and private business. This social philosophy, for which the reviewer has considerable distaste, is implicit in the widely accepted aggregative approach which ignores the individual for the totality which it is desired to control. Whatever one's personal views may be, however, it is essential to attempt to understand the forces at work, and to that end this textbook makes a worthwhile contribution.

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Herbert V. Prochnow (Editor), ***Determining the Business Outlook*** (New York: Harper & Brothers, 1954, pp. 445, price $6.50).

The oracle at Delphi had it much better than the business forecasters of today. Once the sacrifices had been duly offered the priestess went into a trance, and murmured something incomprehensible. Then a temple supervisor took over, interpreting enunciation in a manner as vague as possible. They did not have to bother with factors, determinants, indices, trends, correlations, formulas. Furthermore, whatever happened they could not be fired!

The thousands of men who are trying to guess what the future has in store for the country, for a particular industry or corporation certainly have a most responsible and intricate task. They have to scrutinize all the available indicators, and while trying to correlate the available data, they have to weigh its validity and reliability. Vague interpretations leave then open to the criticism of other forecasters and business observers. They should certainly feel grateful to Mr. Prochnow for this one volume collection of the writings of so many practical economists. A full chapter has been devoted to each of the following fields: durable goods, non-durable goods, fuels, construction, railroads, public utilities, automotive transportation, personal consumption expenditures, and agriculture. The last five chapters are entitled: Prices, Wages and Management; Treasury Receipts and Expenditures and Management of the Public Debt; New Businesses, Business Failures and Inventories; World Markets and Foreign Trade; and "Long-Time Trends." These titles suggest the broad coverage given to the means and methods of business forecasting.

After Mr. Prochnow in his introductory chapter stresses the need of careful planning even for a small business, Mr. Walter E. Hoadley in his discussion of the "Importance and Problems of Business Forecasting" emphasizes the need of giving a good deal of attention to psychological and political factors in addition to the economic ones. The various forecasting methods in use are classified by Hoadley into: 1) the most informal method—what may be called the "sample of one," 2) the "take a poll" method, 3) the "key factor method," 4) the "historical analogy method," and 5) the "mathematical-econometric models" method.

The econometric method consists of selecting principal determining factors and working out their past relationship into a formula or "model." The required statistical data are then placed into the equation and the forecast is completed by mathematical computations. The shortcomings of this formula are the impossibility of including psychological as well as economic factors in an equation, the difficulty of including complex economic operations into a limited number of variables, and the assumption that past and future trends are inseparably linked.

Very appealing to this reviewer is the chapter written by Mr. William H. Dunkak and his associates at Merrill Lynch. In a frank and straightforward manner the myth according to which stock market quotations are considered as reliable indicators of economic trends is dispelled. The stock "market often reflects not what is going to happen but what investors expect to happen—and under such circumstances is subject primarily to the myriads of emotions and errors of judgment characteristic of the predominant role the human element plays in market composition." It is also stated plainly that "considering the many factors involved, reliance on the stock market exclusively as a business forecasting tool would appear to involve risks out of all proportion to the potential benefits to be gained."

In the durable goods field more value seems to be attached by Mr. Kenneth Field to forward buying data and backlogs of orders than to other information. Mr. Field stresses the importance of background knowledge of the analyst himself. Dependable interpretation is according to him 99% background and 1% statistics.

In his paper on the petroleum industry Mr. Albert J. McIntosh points out that his industry was fortunate to develop—with the help of various government agencies—a comprehensive set of data with which to work. The forecasts and surveys made by the petroleum industry are based on break-downs of consumption data by products and users. Though few people are gifted with industrial clairvoyance, the experienced petroleum economist, armed with the available material, "can, to a degree, measure the impact that various outside events have upon the petroleum industry."

With regard to the coal industry Mr. Walter L. Slifer mentions that the main concern of his industry is the availability of orders and of railroad cars—to move the production. It is "not feasible to store coal at the mines." The coal industry has to watch closely the developments in the field of oil usage, as well as the prospects for increases of coal usage by the steel industry, public utilities and other industries. Forecasters are handicapped by the lack of reliable data, "as the total tonnage of coal used in some categories is virtually impossible to determine."

Forecasting of construction activities, according to Mr. Donald S. Thompson, continues to be an exercise in economic logic and intuition, with wide margins of error due to the defects of available data. The weakness of the construction statistics is due to the fact that the data encompass permits and contracts rather than actual funds spent in building. Data available for repairs and alterations seem to understate the actual incurred expenditures.

Professor Jules I. Bogen in the chapter on "Railroads and Public Utilities," emphasized the importance of statistical data provided by these two fields as general business indicators. For measuring short-term business fluctuations, railroad carloading and electric-power consumption are very valuable. These data are, however, of limited value for long-range forecasting. Railroads and public utilities being potential investors and employers, their "investing affects the economy to a greater degree than figures indicate, because of their multiplier effect."

Mr. George P. Hitchings in his discussion of automotive transportation stresses that the automotive industry "not only influences general business activity but is in turn highly sensitive to developments in the rest of the economy." When studying the outlook for trucks, the factors used are: 1) volume of business activity, 2) relative share of total freight transportation, 3) business profits, 4) agricultural production, 5) number of farms, and 6) agricultural income. The outlook for passenger cars is studied from the point of view of growth and scrappage. Data provided by the Bureau of Census, the Bureau of Public Roads, by the R. L. Polk Company, the auctions reports published by the Automotive News, the NADA price books, the World's Automotive Reports, the AMA facts and Figures, the Survey of Consumer Finances, are being used for the projection of households and their composition: the ratio of cars owned to the number of households, etc. For determining the approximate amount of scrappage, registration data are being used. It is interesting to note that the decisions to scrap cars are mostly made by the dealers, who take the cars as trade-ins. The economists working on forecasts for the car manufacturers seem to have no shortage of tools, but as automotive sales are highly sensitive to general business trends, "the most important factor to consider is the level and direction of general business activity."

The chapter on agriculture, written by Mr. Lester S. Kellog, indicates the many sources of information available to the estimators of crops and farm income. The Balance Sheet of Agriculture, the monthly releases of agricultural prices, the index of prices paid and the index of prices received by the farmers, replies to questionnaires sent out from time to time, results of the estimating services of the BAE, private market information services, data compiled by the extensive programs of the departments of agriculture of the various states, are all valuable tools. Agriculture is the only field in which the government assumes the role of a forecaster, by issuing monthly the so-called Crop Production release. Changes in the income of farmers are of prime importance to our whole economy. The indices of prices paid and prices received by the farmers are perhaps the two most important statistical series in the country; they are legally recognized as basis for the price-support program of the Federal Government.

After having read the twenty chapters of the compendium this reviewer wholly agrees with Mr. Prochnow that real benefit from the ideas and experiences of the authors will accrue to the reader who will study one chapter at a time and will digest and analyze its contents thoroughly, before proceeding to the reading of the next. The book contains a wealth of suggestive information, indications of sources, description of techniques—just the kind of food for thought the industrial and business economist is anxious to find and to absorb. The book may also prove useful for an advanced course in Industrial Management at a graduate school, where planning and forecasting has been included in the curriculum.

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Finance

Pearson Hunt and Charles M. Williams, *Case Problems in Finance* (Homewood, Illinois: Richard D. Irwin, Inc., 1953, pp. ix, 510, price $6.00.)

This is a revised edition of a case book in business finance first published in 1949, the original edition having been favorably reviewed in this Review for October 1950, pp. 477–78. In the present edition, as explained by the authors in their revised teachers' manual, fourteen of the original forty-eight cases have been dropped, four

have been substantially revised and twenty-six new cases added. The case book is substantially altered.

The coverage of subject matter in the original edition was already comprehensive. The new cases give increased attention to the implications of credit management policies (credits and collections procedures) for financial management decisions. The problems now also involve greater reference to financial planning and budgeting, a very desirable development.

Many of the cases bring tax matters into consideration. Illustrative tax schedules are provided. However, in view of the pivotal significance of tax aspects in so many business financial decisions, the book may be cirticized for inadequate coverage of all phases of tax problems. But a strong defense may be made by the authors. Tax considerations cannot ignore fundamental financial aspects. Hence it is the responsibility of a case book in business finance to begin by centering attention on financial policies. For consideration of all aspects of the influence of taxation on business financial decisions, an additional course would be required.

The authors likewise forestall criticism of limited treatment of social aspects of business financial decisions. They point out in their introduction that the cases can be used to direct attention to social problems, at the same time providing a basis for understanding interrelationships between individual circumstances and social policies. They hope thereby to provide increased understanding of how to design social policies to take into account individual situations and motivations.

This book continues to provide excellent coverage with respect to range of industries covered and types of financial situations. While the majority of the problems are of recent vintage to provide realism, a sufficient number are placed in a setting of distressed business conditions to call attention to financial planning for possible adverse developments. Good balance between large firm and small firm analysis is provided, with a preponderance of cases in the area of small and medium sized firms. The information provided is of the quantity and detail available to the internal managers of the firm. Hence the emphasis is on the point of view of business management.

This compilation of business finance cases continues to have great value for accountants. They will see increased significance of many of the tools developed in accounting courses. The case book demonstrates the great reliance on accounting data by corporate financial managers. It affords many realistic examples of management uses of accounting information. The case book therefore would be appropriate in courses sometimes given in accounting departments under the label of controllership or budgeting, as well as useful for courses in corporation or business finance.

The book is a model of high quality in range, coverage and thoughtfulness of development. It has given consideration to all aspects of presenting a useful and useable case book in business finance. It will continue to be widely used with great benefit.

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Arthur W. Hanson and Jerome B. Cohen, *Personal Finance, Principles and Case Problems* (Homewood, Illinois: Richard D. Irwin, Inc., 1954, pp. xi, 682, price $6.00).

This college text should stimulate discussion and thought about the many financial decisions all of us need to make constantly. The problems are well designed, but they should be used in conjunction with the Teacher's Manual for best results. The authors point out that the "text is designed essentially for a one-semester, fifteen to seventeen-week course," but that it may be used as a two-semester course "by the simple expedient of spending one week discussing the principles of a given topic and the following week on the extensive case-problem material on that topic given at the end of each chapter and discussed in the Teacher's Manual." Each chapter has extensive references or suggested readings so that any one topic may be more fully explored according to one's interest. The text would also be well suited for use in adult discussion groups or for general reading. Frequent snatches of humor are inserted.

As an accountant this reviewer was a bit disappointed to note that the tables and figures in chapter one did not show certified public accountants as a separate profession, although most others were represented. Also, because the book is so current and practical, it may suffer a defect in that some of the specific information given could quickly get out of date. Particularly could this be true of the discussions on social security benefits, savings bonds, average budgets, and taxes.

The authors state the general organization of the book as follows: "Since most of us have no finances to administer before we start earning an income, we have begun this book with income and occupation, the creating fountain of whatever financial resources the typical individual or family has, Next, attention has been given to the daily living which usually consumes the lion's share of total financial income. The remainder of the volume is devoted to that residual segment of resources, small though it may be, which can provide comforts, satisfactions, and security beyond the basic needs."

Accordingly, chapter 1 discusses choice of vocations, general distribution of income and the relation between income and education. Chapter 2 contains some excellent suggestions and thoughts regarding expenditures and budgets, pointing out the purpose, composition and preparation of a budget together with examples. In chapter 3, charge accounts and installment plans are reviewed. Such things as how to open a charge account, how a person's credit is investigated, and how much a charge account costs are considered. Contracts used in installment financing are discussed showing the method of operation and what the consumer should look out for. The cost of installment financing is covered including a discussion of interest and the costs of installment credit versus bank credit.

Savings accounts and savings bonds are reviewed in chapter 4 with a discussion of savings in general, where one may save, and how the various savings agencies operate including rates of interest paid. The various

ways in which a bank's services may be used and how banks operate are set forth in chapter 5. Chapter 6 discusses the various other lending agencies and related costs of borrowing.

Chapter 7 gives a rather thorough discussion of life insurance starting with a brief review of insurance theory and explaining the advantages and limitations of the various types of insurance coverage. Types, costs, and advantages of annuities and benefits of social security are discussed in chapter 8. An interesting section shows four hypothetical life insurance programs tied to a social security base. Chapter 9 covers general insurance including health, accident and insurance on the home and automobile, with discussion of rates, advantages and limitations, and what to watch for in the various contracts.

In chapter 10, all the aspects of buying or financing a home are discussed. Why people buy instead of rent, building or buying, how much should be paid, some practical suggestions as to location and appraisal of the home, how to finance the home and cost of financing, some things to look for in the purchase contract, how to close the loan, information as to deeds and titles, GI loans and FHA, and the relation between death, mortgages and insurance are all covered by this chapter.

At this writing, Congress has just passed the new tax law. It is a little too early yet to tell whether such law has made obsolete parts of chapter 11 on taxes, although the chapter is written in such a way as to make this doubtful.

Chapter 12 gives an introduction to investments starting with a general discussion of business and moving rapidly into consideration of stocks as an investment, as to ownership, as to objectives and as to stock rights. Bonds are then considered. Rules for investors, diversification, when to buy, how to buy including formula-plan investing and dollar averaging, what to buy, and comments on where to buy with some general information are treated in chapter 13. How to acquire investment information is the subject matter of chapter 14. Such sources as investment counsel, financial publications, industry surveys, financial services and brokerage houses are reviewed. The use of the balance sheet and income statement to the investor is shown. Chapter 15 is a general discussion of investment companies as to kind, type, operation, portfolio, earnings and how to measure performance.

Investing in a small business is the subject matter of chapter 16. Some of the questions examined are: Are you qualified to run your own business? Is it better to start a new business or to buy an existing one? What to look for in buying a business, how to use a business broker. What should a business cost? How much rent should you pay? What return should a small business yield? How to know your costs and profits. Which form of business organization is best? What insurance for the business? What are the chances of success? What causes failures?

The last chapter discusses wills, trusts, and estates; death and gift taxes. Numerous charts, graphs, figures and tables are used throughout the book to illustrate the various points.

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General

Raymond Villers, *Dynamics of Industrial Management* (New York: Funk & Wagnalls Co., 1954, pp. xix, 546, price $6.25).

Raymond Villers has come pretty close to distilling between the covers of his stimulating and provocative book most of what is known today on the subject of industrial management.

Dr. Villers' discussion and evaluation of the work of Babbage, and of the division of labor as it existed in the early 19th century, gives the reader a ringside seat at the birth of the infant science. He then traces its growth, and shows us how with the assistance of Towne, Taylor, Kendall, and others it had by the end of the 19th century reached what might be called the adolescent stage. Taylor's contributions to the techniques of industrial engineering, especially as they influence the productive unit, and his unshakable belief that man's over riding expectation from his job is his pay check, are discussed at some length.

The author goes on to show that today the scientific management movement has arrived at a stage somewhat akin to early adulthood. But today, 1954, it faces a serious challenge—the need to do something about the corroding impact of the conjunction of excessive specialization and large plant size upon man's fundamental craving for self accomplishment. Since the trend toward specialization is irreversible, and since in some industries large plant size will probably be with us for years to come, there are those who see nothing but calamitous frustration ahead. To them, the science and the practice of industrial management, while continually raising man's standard of living economically, offers little hope of freeing him from the machine's bondage.

Dr. Villers, while agreeing that industrial management does face a serious challenge, refuses to accept man's becoming enslaved by the machine and thereby being blocked forever from realizing his highest aspirations. As he puts it, "The problem is to organize the industrial enterprise in such a manner that it can function economically and at the same time enable its members to satisfy their basic needs, their sense of purposeful accomplishment, and their legitimate ambitions to develop freely their own personality." . . . "The problem of modern industry is to integrate its human, technical, and economic elements, so as to keep a balance between the requirements of the organization for unified action and legitimate aspirations of the individuals

who make it work." In the first quote, the action word is *organize*, in the second, it is *integrate*. Taken together and applied to industrial enterprises, these two words add up to Villers' basic idea—*reorganization*. In a sense, the whole book revolves around that dynamic process. The author hammers away at the do's and don't's of reorganizing as well as at the procedures and policies which should be used in the management of well-integrated enterprises. *Cooperation*, *coordination*, *control*, *imagination*, *objectivity*, *balance*, *acceptance*—these are the intangibles that keep popping up at the reader from almost every page. Numerous illustrative case studies are presented.

The survey of a company, one of its departments, or even a function, can not be successful if cooperation and objectivity are not maintained between the survey team and the personnel of the activity being surveyed. The survey report itself would be sure to antagonize people and obstruct the reorganization process if it lost objectivity through dealing in personalities and if it lost balance by giving minor recommendations equal space and weight with major ones. The importance of the foregoing intangibles are immediately recognized by the experienced reader.

As the survey and the reorganization itself progress, standards, charts, basic management records, and effective channels of communication need to be provided. Reports needed by various levels of the management of the newly reorganized enterprise include: sales and production schedules, break-even charts, profit and loss charts, unit costs, sales mixture charts and financial statements. Recommended format and data to be recorded are described in detail. The intangibles continue to be stressed—the dominant ones being *coordination* and *control*. To secure these, Dr. Villers describes the need for, and the proper workings of, a Planning and Control Department. This department is the balance wheel, the essential that makes possible the concept and practice of decentralized authority and responsibility with centralized control. It allows management to delegate authority and responsibility because it keeps management adequately posted on the current health of the business. Any illness can be detected by studying the pertinent reports, trend charts, graphs, tables, etc., in time for the proper treatment—management action. Not only does Planning and Control free higher levels from crushing detail, but it assists in executive development and it provides more personal satisfaction for more people. Planning and Control though must always remember that it is a service department. It does not issue orders but assignments subject to acceptance by the departments. It tells these departments what to do and when but not how.

In his discussion of budgetary control, the author emphasizes the importance of preparing and maintaining departmental expense budgets, while at the same time he cautions that they can introduce serious proplems of human relations if poorly administered. Dr. Villers believes the cash budget to be equally as important as are the expense and sales budgets. He points out, however, that larger variances should be expected to occur in the cash budget than in other budgets.

The discussion of long range planning is particularly valuable because of the enlightened treatment given the subject of personnel management and new product development. That increased horizons are bound to be acquired by those who give long range planning its deserved attention can not be easily contested.

In the last chapter, the author focuses attention once more on the dilemma facing industrial management. He sees the solution to be the creation of small self-sufficient manufacturing units or if the nature of some businesses prevents their creation, then functional decentralization must be resorted to so that "The decentralized units (functions) can be made sufficiently small in terms of human relations." He concludes with the optimistic statement, "The science and the practice of Industrial Management, now working in closer and closer cooperation, have opened the way to the solution of the human, organizational and managerial problems created in the modern industrial enterprise by the irreversible trend toward increasing specialization."

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W. D. Knight, ***Profit and Loss Budgeting*** (Madison: University of Wisconsin, Bureau of Business Research and Service, 1954, pp. 62, price $1.15).

This book contains three case studies made in cooperation with the National Society of Business Budgeting (Milwaukee Chapter) and was undertaken for the purpose of highlighting the budgeting process as a practical business tool. The three firms selected differed in size and industry, and their heterogeneous experiences provide a wide area for comparison. Allis-Chalmers, the largest firm in the group, is a manufacturer of farm, construction and electrical machinery and uses a job order cost accounting system. Kimberly-Clark is a process manufacturer of paper products and utilizes a standard cost accounting system. Snap-On-Tool Corporation, the smallest of the three, is a manufacturer of socket wrenches and related tools, and also employs a standard cost accounting system. The differing nature of their production processes, product lines managerial concepts of sound budgeting techniques, managerial objectives, and their varied sizes necessitated the use of an individualized approach to the budget program. Whenever possible, an attempt was made to point out those features which were common practices employed by all of the firms as opposed to those which were distinctive with the individual firm. The reasons for these repetitive and unique applications are also explored.

The cases deal specifically with such problems as profit and loss forecasts, development of cost standards, cost control, product line control, fixed versus variable cost budgets, the importance of budget flexibility, the methods employed by the various managements in developing the budget, and the procedures employed in applying the results of the budgeting activity. As might be expected the firm size as well as the diversity of the product line are shown to be factors which require

adaptation of control techniques. In this connection the author has noted that all three firms stressed the importance of tailoring the budget to the individual enterprise and that a "standardized approach to budgeting" would be unlikely to satisfy the needs of the management using such a system.

While the author stresses the importance of budgeting for planning and control purposes, he recognizes it as a tool which is intended to facilitate management's function and as such should only be used if it serves this role best. Indeed he states, "As management comes to understand the language of budgeting and to regard it as an effective means of communication both for keeping track of the operating situation and for developing and implementing management plans and programs, it will become convinced of the value and use of budgeting. If other simpler or more effective means for accomplishing these purposes are available to management they should, and will, be used."

The author succeeds in explaining the mechanics as well as the human factors that are involved in the preparation of a budget. He makes a point of repeating those salient features of a budget system which all of the participating firms accepted as basic to achieving success with the budgeting technique. As a result, certain fundamental principles are easily noted. While on the whole the text is presented in a clear and lucid manner with adequate illustrations, there are times when more elaboration would have made some of these illustrations easier to follow.

This study makes good reading for those interested in viewing the practical application and implementation of budgeting techniques in real business situations. However, some of the accounting data that is presented to illustrate the mechanics of operation is of a technical nature and comprehension may not be too easy for those in management lacking an accounting background.

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Calvin F. Schmid, *Handbook of Graphic Presentation* (New York: The Ronald Press Company, 1954, pp. 316, price $6.00).

This book is a digest of approved graphic practices, leavened with the author's own experience, and flavored by his major interests and activities. It is a good general review of how to plan and prepare 'statistical' charts and maps. The principles and procedures described certainly apply to presentation problems met in many fields of work and study.

The book is divided into eleven chapters: one each on principles of chart design and drafting techniques, five on kinds of charts and how to use them, one on map presentation, two on graphic treatments, and a final chapter on reproduction processes. A supplementary section contains a source index and a subject index.

The chapter on principles is clear and concise. It would be even better without the final section about the steps in drawing a chart. This and the Drafting Techniques chapter, mostly about drafting equipment, belong more logically in an appendix.

Curve and surface charts are discussed in detail in Chapter 3. The title "Rectilinear Coordinate Charts" may frighten some readers and confuse others not aware that most of the charts in this book are based on the same scheme of two scales crossing at right angles. Nevertheless, the explanation of curve and surface charts is clear and thorough. Chapter 4 systematically reviews the forms and uses of bar and column charts. The chapter on semi-logarithmic charts is clearly written, if a trifle too enthusiastic. The author says, "In comparison with the arithmetic line chart it possesses most of the advantages without the disadvantages." Similar strong statements suggest that arithmetic charts are all but worthless. This chapter would be more helpful if it stated clearly that semi-log and arithmetic charts serve different purposes, and that using one for the other is simply a mistake. Frequency charts, one of the author's favorites, are discussed with special enthusiasm. This chapter provides a careful explanation of the different types of frequency distribution and the various forms of frequency presentation. Chapter 7 "Miscellaneous Graphic Forms" contains an excellent discussion of pie charts, although more examples of how not to use them would make it even better. Relationship charts are treated a little too briefly to do them justice; and trilinear, organization and flow charts are described only casually.

Statistical maps, another of the author's favorites, are given a lively treatment. This chapter contains many sound ideas and suggestions about map presentation, especially about presenting detailed information within a state or city.

Chapter 9 carefully explains the uses and limitations of pictorial charts. The author wisely points out that they are suitable only for the simplest kinds of comparison, and that they are always more costly to make.

The vogue for three dimensional charts seems to be increasing, and Professor Schmid has performed a service by including a thorough explanation of this treatment, with recommendations on how it should and should not be used.

The final chapter on reproduction processes is helpful, not only for its coverage of the major methods, but also for its emphasis on the controlling influence that the form of reproduction has on the way the chart is prepared.

In general, the content of this book is sound and accurate, although there are a number of small inconsistencies. Most of the writing is direct and specific.

In a book about graphic presentation, the illustrations are the proof of the pudding. In this book, the illustrations are well conceived and designed, and serve as excellent models. The subject matter in the illustrations is not always so successful. "Fertility, by Age of Female" and "Full-Time Faculty Salaries, by Rank" are intriguing enough subjects, but when added to an already full share of similar social and educational data, they crowd out subjects that could be more helpful in suggesting how the form of the illustration could be used in other fields.

The chief value of this book is that it brings together the major standards of graphic presentation, and supplements these with information about special forms and problems not covered in the official "standards." It puts under one cover a valuable collection of graphic principles and procedures that the reader would otherwise have to search for in several volumes. No similar book that this reviewer recalls has credited so many idea sources. The main outside sources of this book are "Time Series Charts," a manual published by the American Society of Engineers and approved by the American Standards Association, "Standards of Presentation" issued by the office of the Comptroller, Department of the Army, and publications of the American Statistical Association.

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Taxes

JOHN C. BENNETT, *The Federal Income Tax Calculator—1954* (Charlotte, N. C.: Paramount Publishing Company, Inc., 1954, pp. 54, price $2.00).

Although the title of these tables does not show any limitations, they cover only joint and separate returns of married persons and returns of single individuals who are not the "head of a household."

Obviously, short-cut tax calculators are of a good deal of value to the tax practitioner, because they are time savers and provide a safer double-check on calculations than does a mere repetition of the original complete calculation. The designer of *The Federal Income Tax Calculator* properly recommends that (1) initially the computations for Form 1040 be based upon the official rate tables—"splitting" income, applying the official rates, and doubling the result when joint returns are involved—and (2) the result be checked to the calculator tax tables, which do not require "splitting" of income and the doubling of the tax result for two spouses.

Since a mere word description of the layout and use of tax tables is difficult to visualize, a few sample lines and columns have been abstracted from the tables and used for illustration. In order to condense the presentation, a few very minor liberties have been taken with the actual form:

This arrangement is followed in the first 37 pages, which cover incomes up to $18,000 on separate returns and $36,000 on joint returns. The layout is changed for larger incomes, and different pages are used for separate returns, apart from joint returns.

To illustrate the use of the tables, assume joint return income of $3,998.18. For actual entries on Form 1040, the taxpayer may use the official tax tables or these calculator tables. The latter are applied in this fashion:

(a) "Split" the income	$1,999.09
(b) Tax on $1,900.00	$ 380.00
(c) Tax on $ 99.00	19.80
(d) Tax on $ 0.09	.02
	$ 399.82
(e) Multiplied by two	$ 799.64

For checking purposes, the right-hand column in the tables can be used more conveniently, thus:

(a) Tax on $3,900.00	$ 780.00
(b) Tax on $ 98.10	19.62
(c) Tax on $ 0.08	.02
Total	$ 799.64

$.01 to $2,000 20%							20% $.10 to $2.000			
Separate Returns[1]		*Dollars*	*Cents*				*Joint Returns*[2]		*Cents*	*Tax*
Hundred Dollars	*Tax*		*.00*	*.10*	*.80*	*.90*	*Tax*	*Hundred Dollars*		
$ 100	$ 20	$ 0	$ .00	.02	.16	.18	$ 20	$ 100	1	.00
200	40	1	.20	.22	.36	.38	40	200	2	.00
1,800	360	98	19.60	19.62	19.76	19.78	760	3,800	3–7	.01
1,900	380	99	19.80	19.82	19.96	19.98	780	3,900	8–9	.02

[1] Also used for "split" income in the actual preparation of a joint return Form 1040.
[2] Used for quick reference and for checking the final tax on joint returns, without the necessity of splitting income and multiplying tax by two.

The Federal Income Tax Calculator is pocket size (8"×4"×⅛"), spiral bound, well printed, and on good paper stock. Assuming that the tables have been computed accurately, it is my opinion that they are thoroughly adequate for convenient use and for saving time in applying tax rates in returns of married persons and single persons not the "head of a household."

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COMMERCE CLEARING HOUSE, INC., *Procedure and Practice before the Tax Court of the United States* (Chicago: Commerce Clearing House, Inc., 1954, pp. 286, price $4.00).

Every taxpayer who has a tax controversy has two separate and distinct courts to which he may appeal for adjudication of his case. He may pay the tax as determined in the deficiency notice and file a refund claim and, if this is unavailing, sue in the Federal District Court, or he may forego the payment of his tax and petition the Tax Court for a redetermination of his tax. Where deficiencies asserted are beyond the means of the taxpayer to pay it is of vital importance that he have his case heard before the Tax Court if he is to have a judicial determination of his tax liability since he cannot pay and then sue in the Federal District Court for a refund.

The taxpayer's right to petition the Tax Court exists for only a short period (90 days) during the entire time his tax is in dispute, and it is important, therefore, if he desires to have his case heard by this court, that he take timely and proper action.

The prime importance of the subject publication is that it points out in clear and non-technical language the basic problems confronting the practitioner in getting his petition filed with this court. To the inexperienced the matter of the filing of the petition may seem to be a relatively minor matter in the over-all problem of the settlement of tax controversies. As this book so clearly points out, however, there are cases after cases wherein the petitioner has failed to have the court hear his case because of his failure to comply strictly with the statute or rules as to jurisdiction. This problem is primarily one of the uninitiated but many an experienced practitioner has also fallen along the wayside. It is well stated by the publisher in the preface:

> "It is not always an advocate's first case before the Court which is dismissed for failure to conform to the rules; even the experienced practitioner must frequently wish he had consulted an authoritative guide on the settlement of doubtful questions."

The principal topics with which this book deals are:

1. Problems of jurisdiction.
2. Pleadings.
3. Presentation of the case.
4. Appeal rights and procedures.

In addition to editorial comments on the various topics there is a section of forms which should be of inestimable help to anyone whose practice includes work before the Tax Court.

The text material deals in sequence with all phases of a tax controversy from the initial determination of a deficiency through the filing of the pleadings, the presentation of the case before the court and finally the matter of an appeal from the court's decision. While it is probably true that a small percentage of accountants try Tax Court cases themselves, nevertheless it is of importance that anyone whose practice includes the handling of tax controversies understand the many problems of evidence and procedure involved in the trial of a case before the court.

The text is clearly written and the basic elements of Tax Court procedure are adequately covered. One good feature is the extensive footnotes referring to cases or the statute concerned. The user of this reference work will find many helpful references in connection with his problem.

It should be emphasized that the reading and study of this book will not qualify an untrained person for court practice. It is the reviewers' opinion, however, that this is a reference book which could well be in the library of any accountant.

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JACKSON L. BOUGHNER, *How to Save Taxes Through Proper Accounting* (New York: Prentice-Hall, Inc., 1954, pp. xv, 295, price $5.65).

Here is a book that breathes some fresh air into the turbid atmosphere of the Federal income tax field—in spite of a rather misleading title.

The author's approach is best exemplified in Chapter 1, entitled "The Basic Principles of Saving Taxes." After quoting George O. May's statement that income taxation presents a three-fold question, "What is taxable income?" "To whom is it taxable?" and "When should it be taxed?" the author says:

> "These three questions are the clue to tax savings methods. Eliminating receipts from the status of taxable income, transferring property and its attendant income to a taxpayer in a lower bracket, and postponing taxation from a year when you are in a high income tax bracket to a year of a lower income bracket are the three basic approaches.
>
> "The role of accounting is most important in dealing with the third question, the time of taxation."

This reviewer is in complete agreement with the author regarding the good business sense implicit in the three basic approaches to tax savings outlined above. The title of Mr. Boughner's book is, however, "How to Save Taxes Through Proper Accounting." Are we to assume that "proper accounting" is synonymous with "tax savings," or with " . . . postponing taxation from a year when you are in a high income tax bracket . . . ?" Surely the word "planning" substituted for "accounting" in the title would correct this unfortunate implication.

The 26 chapters in this book fall into four natural sections:

Chapters 1 to 3—the basic "rules of the road"
Chapters 4 to 6—methods of accounting
Chapters 7 to 19—income and expense

Chapters 20 to 26—fiscal years, forms of organization, excess profits taxes, etc.

The first group of chapters presents an excellent treatment of the dangers of entering into business transactions without considering the tax effects.

Section 2, in addition to discussing the tax consequences of cash, accrual and hybrid methods of accounting, develops a realistic picture of the degree of control over income and expense that is possible through an intelligent choice of method to fit the varying needs of different groups of taxpayers.

The third group of chapters deals with income and expense. In Chapter 9 the variation in income produced under different inventory methods is clearly portrayed. Chapter 10 presents a useful analysis of the tax effects of investments in real estate, mortgaged property, etc. Three chapters—14, 15 and 16—are used to develop the tax status and consequences of alternative means of compensation. Thus salaries, fringe benefits, business expenses, pension and profit-sharing plans, stock bonuses and options are discussed and their tax effects explored.

Section 4 is highlighted by a summary tax questionnaire which provides a good review of the completed return.

To this point one inescapable criticism has not been mentioned. This book is obviously the product of many years of thought and many years of tax practice. It was published, however, in May of 1954. On August 16, 1954, the Internal Revenue Code of 1954 became law. This Code, in the words of the reporting committee represented "the first comprehensive revision of the internal revenue laws. . . . " Thus, while the majority of the author's work on tax planning is as effective as ever, the references to code sections are outdated and specific topics have changed materially under the new Code.

The need for a book of the type written by Mr. Boughner is a very real one. The author has a clarity of expression and a type of presentation that should find favor with a wide range of businessmen. This reviewer sincerely hopes that a revised edition of this book will soon be forthcoming.

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Teaching

Malcolm P. McNair (Editor) assisted by Anita C. Hersum, *The Case Method at the Harvard Business School* (New York: McGraw-Hill Book Co., Inc., 1954, pp. xiii, 292, price $5.00).

This is a symposium of 28 pieces by 25 different authors, nearly all presently or previously engaged in teaching the "case method" at the Harvard Business School. The oldest contribution is the first, *An Introduction to the Use of Cases*, written by Arthur Stone Dewing in 1931. Many of the other articles are also reprinted from other sources, but the bulk of the book consists of articles prepared for this volume by current students or instructors at the school. The book suffers somewhat from the usual redundancy and contradiction of such a collection. It is however uniformly well written, though (like a casebook) it is not at all easy going. There is a great deal to gather in and think about and the cumulative effect is both rewarding and exhausting.

Generally speaking, the book starts out with rather extravagant praise and ends on a somewhat more cautionary note. The earlier articles and the most extreme in their all-out advocacy of the case method are by the older contributors, men with many years of experience teaching by this device; whereas, the later and less enthusiastic are those by the younger people closer to the scene now, or perhaps to other methods. An example of extremity of praise is the following introduction from the second article, *Because Wisdom Can't Be Told*, by Charles I. Gragg:

> " 'So he had grown rich at last, and thought to transmit to his only son all the cut-and-dried experience which he himself had purchased at the price of his lost illusions; a noble last illusion of age. . . . '—*Balzac*
>
> "It can be said flatly that the mere act of listening to wise statements and sound advice does little for anyone. In the process of learning, the learner's dynamic cooperation is required. Such cooperation from students does not arise automatically, however. It has to be provided for and continually encouraged."

After several doses of this sort of thing, one wonders how the first teachers of the case method ever got an education themselves, or whether it can really be possible that no one has an education except a graduate of the Harvard Business School. It may be said in passing that the book itself is conventional in its approach; it educates us about the case method without very many cases. The book contains little or no appraisal by "outsiders" and none by experts in education or psychology.

Cases are "stories," with the end left off. They usually run around twenty or thirty pages, sometimes one, sometimes many pages. In text form, usually with a good deal of accounting and statistical data included, they set a stage in a real business, tell a good deal of what has happened, pose some problems currently facing the management (sometimes not too clearly), and leave the student dangling, wondering what he is supposed to do next. Sometimes there are a few questions at the end of the case, but more often not. The case method, by the way, has nothing in common with our "problem" approach in accounting. It is something entirely different from that, as it is from the "lecture" or "recitation" or "discussion" or "seminar" or any other teaching method. The general idea is that the case method provides in the teaching of business something like what law schools get with their reported cases, or what medical schools get with their teaching hospitals or their cadavers.

But one does not understand the case method until he has really tried it as student or instructor. Though few schools are teaching accounting this way, most of

our business administration colleges have some instructors and some courses using Harvard case books. The accounting professor who wants to find out something about it should start out by teaching one of these other courses, using the materials and outlines already available and perhaps sitting through a few practice sessions. It is not essential to know the subject matter of the particular field, and indeed at Harvard beginning instructors are passed around through the various courses before they settle down in any particular field. Subject matter is not what is taught and subject matter knowledge is not what is required for the teaching. Teaching experience by other techniques may or may not be helpful; it is my observation, though, that business experience of a broad and varied character may be helpful.

As to size of class, Harvard has used the method in from groups of six to more than 100; in his article *Use of Case-Material in the Classroom*, Robert W. Merry recommends 40 to 80. My own inclination would be to prefer 15 or 20, but mainly in order to use more of the related "role-playing" technique along with the case method. As to written assignments, Merry says:

> "The students cannot prepare a number of acceptable written papers each day, give the necessary attention to the succession of longer assignments always pending, and still keep their academic engagements. Ordinarily, with their notes to refresh their memory of the case and of the thinking which accompanied their preparation, the students come to class sufficiently equipped to make an intelligent contribution to the class development of the case. Except in unusual circumstances, the written analysis of cases for daily classroom discussion does not produce results commensurate with the effort expended by the students."

Usually one case is assigned per session, and what happens is that the session is "thrown open" for discussion. In the classroom, as is said by Kenneth R. Andrews in *The Role of the Instructor in the Case Method*,

> "However his judgment prompts him to behave in the classroom, the instructor plays a multiple role. He is student, listener, and analyst. He is questioner, paraphraser, and minuteman lecturer. He plays these parts without costume changes, and he never steals the show from the rest of the cast."

Without the actual experience, one's first reaction to all of this is that he would be surprised if anything at all were accomplished; this was my own reaction after I had read about it, but before I had tried it. But after one tries this method, he is surprised at how much can be accomplished. He will also be surprised at how hard he has to work. At first, one would think that if the instructor did not have to make a lecture, the students doing all the thinking and the talking, then the teacher would not need to work very much or even, perhaps, to be there. But this is not the case. The professor will find the cases frustrating in the extreme and he will not enjoy the experience of having to find an answer without knowing what the question is. He will also be surprised at how inadequate may be his best-remembered principles and experiences in the presence of an actual situation to which they need to be applied, provided he can think of which ones to apply. His reactions will be those indicated by Donald R. Schoen and Philip A. Sprague in their article, *The Case Method as Seen by Recent Graduates*—"An initial reaction of frustration, an arousal of curiosity, a development of insight, and a final achievement of administrative power"—he hopes.

Just what is it that is taught in the case method? My impression is that what the students learn is the superficial characteristics of the particular industry of each particular case, as well as some proficiency and confidence in the attacking of problems, but they learn no generalizations. The objective seems to be to arrive at a decision with what facts are available, or with or without facts, though even on this there is no real general agreement. Mr. Merry says: "Under the case method, the objective is to arrive at a decision, ordinarily a decision as to action to be taken." Powell Niland in *The Values and Limitations of the Case Method*, says, "There sometimes results an over-emphasis on positive decisions, decisions to take action where action may not be justified and force a solution where none is feasible." But one thing is clear. The teacher avoids even the appearance of enunciating "principles," though occasionally a little time may be devoted to "development of currently useful generalizations."

Indeed, the case method reflects a new idea about principles, that they are not useful in the modern world. The following is quoted from the long-time Harvard dean, Wallace B. Donham, in his contribution, *The Case Method in College Teaching of Social Science.*

> "In the world today the kind of security that existed in England and in this country in the last century has disappeared, and disappeared for a long period ahead. With it disappeared the last excuse for the old educational system. It may have been well adapted to what Elton Mayo refers to as an established society, where it seemed permanently worth while to learn theoretical principles, rules, and precepts because they would continue to be pertinent to men's needs. We no longer live in such a society, but we have yet to work out educational objectives and method adapted to present needs.
> " . . . The major problem of education, it seems to me, is to give men a sense of internal security, assurance in their capacity to get on with people collaboratively and to deal successfully with the unpredictable future, which will take the place of the type of security provided by the established society of our ancestors."

The idea, thus, is to take situations as they come and attack them, blindly swinging if necessary. This is the opposite of the scientific method. There is neither deduction nor induction, no drawing of principles and no testing of hypotheses.

Yet there is a broad philosophy. Consider the following by C. Roland Christensen and A. Zaleznik in *The Case Method and Its Administrative Environment*,

> "The case method is much more than a simple teaching technique. It is an educational process

which provides a means for examining and learning from our experience, whether as students, teachers, or administrators. The constant examination and re-examination of our own experience through the medium of the 'case' lead to an atmosphere in the school which is marked by change and new relationships rather than by stability. The main idea which we want to state in this paper, therefore, is that the case method demands a unique contribution from the academic administrator which makes it possible for all participants to learn in an environment of change and uncertainty and to gain satisfaction in doing so.

" . . . The case method makes some unusual and exacting demands on the participants. From our own experience as instructors, we have found that it places us under certain stresses because, as applied in teaching business administration, the case method creates an environment of change and uncertainty which we attribute to three facts: first, we are dealing with *business* as a world of risk and uncertainty; second, we are dealing with *administration* as an evolving concept; and, finally, we are dealing throughout with a *situational approach*."

The "case method" carefully avoids any indication of how the case actually came out in actual practice or apparently any indication by the professor, if possible, as to how he would like to have handled it or to have seen it come out. There is no "answer." This leaves a kind of vacuum. How can one learn from experience if he does not know what was tried and how it came out? But it seems to be that the instructor can, with validity and within the method, do something about this. Many of the cases in the standard books are identifiable and many of them are quite old now. One can look them up in *Moody's*.

There is, perhaps, a danger that a student might be led to believe that he actually can solve management problems with neither data nor principle. Indeed, it must seem to us teachers that it is a peculiar educational process that involves arriving at no generalizations. Yet there is another way to look at this, and it is very important that we do so. The student who comes out of his education with the generalizations but with no education in applying them may be badly off. I would conclude from this, then, that the case method is not for the teaching of subject matter nor of principle, but that it has a real place in the teaching of application; therefore, it would be of value for top integration, but inferior for basic principles courses. It might be better for training businessmen than for training teachers. While there is no "carry-over" from the cases to other applications, there is a great deal of "carry-in" to the cases of common sense and ability to observe and express that the student will have to have been born with or have acquired somewhere else. What the student learns in the case method is what is taught there—that is, something about an industry and a company and a group of people and a problem, and he learns about attacking problems. This is educationally worth while.

About the case method, Harvard's former president, James B. Conant, says, as quoted by Arthur H. Tully, Jr., in *The Financing of Case Collection*,

"The great success of the Business School during the war years in training supply officers for the armed services and analyzing many logistic problems might be said to justify those who see this faculty of the University as the one academic group which knows how to teach 'administration.' I realize, of course, the strenuous objections that many graduates of our Law School now serving the Government in administrative posts would make to any such contention.

"Interesting evidence, however, is afforded by the brilliant record of the Advanced Management course of thirteen weeks offered to business executives in the last ten years. Furthermore, the testimony of employers and alumni is almost unanimous as to the value of the regular two-year course for those who are going to enter business. As one who has done little more than observe and applaud this Harvard development, I suggest the key to the success has been the insistent and persistent use of the highly expensive case method of instruction."

It is very expensive. Harvard has spent upwards of $5,000,000 to gather its 20,000 cases. The cost per case ranges from $100 to $1000. The entire task is supported by the "Associates of the Harvard Business School," with now 335 memberships, mostly in corporate names.

The method is used in Harvard in all their courses, including accounting, commonly lumped with statistics in what is called "controls," but also in courses called financial accounting, industrial accounting, and administration and review of accounts. Mimeographed case material is available in all of these fields, but there is only one published case book in accounting, that of Professor C. B. Nickerson, *Cost Accounting, Text Problems and Cases*, reviewed elsewhere in this issue of the ACCOUNTING REVIEW. Thinking about our ordinary accounting curriculum, I am inclined to think that the case method might well be appropriate to analysis of financial statements, administrative controls of all sorts, tax work, auditing and very likely cost accounting. Case books available in some of the other fields could be used in accounting to some extent—for instance, Hunt and Williams, *Case Problems in Finance*, also reviewed in this issue of the REVIEW. Case books in all fields, by the way, make extensive use of accounting data. That is very flattering to accountants, but appalling in the frequent lack of understanding of the shortcomings of such data (our own fault, more than anyone else's).

Further reading on the method will be found in Chapters ix and x of Planty and Freeston's *Developing Management Ability*, Ronald, 1954; in Smith's *Policy Formulation and Administration*, Irwin, 1953 (the introduction); and in the introduction to Newman's *Administrative Action*, Prentice-Hall, 1951.

My own impression is that the case method is something we ought to know more about than we do. A good start is to read this book; even better is to teach a course. Both the book and the method are well worth a college professor's attention.

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